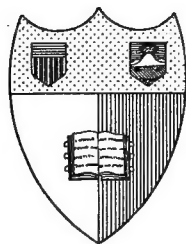


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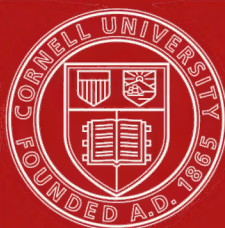
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BUSINESS FINANCE

A Practical Study of Financial Management in Private Business Concerns

BY

WILLIAM H. LOUGH

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PREFACE

This book, as its name indicates, is concerned with the every-day financial problems of the private business concern. The point of view taken throughout is that of an organizer or financial manager of an enterprise. While the book deals primarily with business conditions and financial practice in the United States, it includes many references also to the experience and practice of other countries which may yield suggestions of value to American business men.

Many social and economic questions are necessarily touched upon incidentally. These questions, however, in the author's judgment, belong to a separate field of study; no attempt is made, therefore, to discuss them at any length.

The subject matter of the book falls naturally into five distinct parts :

Part I begins with a brief exposition of the essential principles of all sound financing; it is devoted for the most part to a description of the different forms of financial organization of business enterprises, taking up in turn the individual proprietorship, the firm or partnership, and the corporation.

Part II discusses the various forms of security issues and the manner in which they may be combined and organized as determined by the basis of capitalization of the particular enterprise.

Part III treats of the methods of raising capital through the sale of securities and the usual forms of promotion and underwriting.

Part IV deals with efficient financial management; how capital funds are invested; how the amount required for working capital is ascertained; the proper management of

capital and income through budgets; and some of the financial standards which should be kept in view.

Part V treats of financial mismanagement and irregularities, and of the processes of reorganization.

This very brief review is enough to make clear the main purposes of the book and the groups of business men to whom it is designed to prove useful.

The first group, whom the author has had constantly in mind, consists of organizers, directors, and executive officers of business concerns of all classes. It is hoped that they will obtain from the book many helpful suggestions which they can put to practical use.

The second group consists of bankers, bond dealers, and other financial men who are continually investigating and criticizing the financial management of enterprises.

There is a third group, composed of engineers, lawyers, accountants, and other professional men, who are frequently called upon to advise as to financial questions, although they are not necessarily well informed on these subjects.

The previous literature on the subject has been so scanty that the book to a considerable extent necessarily breaks fresh ground; and this must be the author's excuse if sometimes the treatment of a topic seems to be incomplete. This remark applies with special force to the chapter on "Financial Standards"—a subject to which a great amount of research could profitably be devoted.

WILLIAM H. LOUGH

New York City,

April 9, 1917

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BUSINESS FINANCE

Part I—Finance and Business Organization

CHAPTER I

PRINCIPLES OF FINANCING

Scope of Subject

In this volume is considered the subject of securing and handling money and credit for business enterprises. If these terms were used with strict accuracy, the statement might be shortened by leaving out the reference to money; for, after all, credit in one form or another is almost the only element with which we have to deal. But it is not necessary here to enlarge upon these technical limitations.

Financing deals, first, with the raising of the initial capital needed for business enterprises, what securities to issue, how and to whom they should be sold, how best to utilize the funds thus secured, together with their proper apportionment for plant, equipment, and working capital; second, with the accurate determination of profits and their allocation to dividends, surplus, sinking fund and reserves, and the enlargement of capital permanently invested. It is concerned with the forecasting of business development and resulting financial needs and with provision for the business equivalent of a "rainy day."

Unskilful Business Financing

Financing is, perhaps, the least understood subject in the field of business, not even excepting accounting. A great

many men have proved themselves able and successful as producers, organizers, and sellers, but have failed utterly in handling their financial problems.

A conspicuous example was the late Mr. George Westinghouse, the brilliant inventor, organizer, and salesman who founded the Westinghouse Electric and Manufacturing Company, the Westinghouse Air Brake Company, and other enterprises. Mr. Westinghouse made a success of every business enterprise he touched *except* in so far as financing was concerned. He apparently was not familiar with financial methods and did not possess the foresight to keep his enterprises properly provided with cash as they progressed. Consequently, he was twice faced with serious embarrassment and in the end was compelled to relinquish the management of the Westinghouse Electric and Manufacturing Company.

This case is not an uncommon one. In fact, it is quite generally true that men of an optimistic, emotional turn of mind who make good as producers and salesmen are just the men who deceive themselves as to their own financial affairs and often wreck a promising business on some financial reef.

It is surprising to find how many directors of important corporations give insufficient attention to the basic financial problems of corporate business. Frequently insolvency, which should have been clearly foreseen, comes upon a board of directors when they fancy their company to be at the height of prosperity. This was true, for instance, of the insolvencies during recent years of the National Cordage Company, the American Malting Company, the National Asphalt Company, the United States Realty Company, the New England Cotton Yarn Company, and the Westinghouse Electric and Manufacturing Company.

Among smaller concerns the amount of ignorance regarding financial management is even greater. Every experienced business man probably has observed instances where profitable

enterprises were half developed and then abandoned for lack of funds, when, in nine cases out of ten, the whole financial process might have been figured out in advance and the necessary funds raised with little difficulty. Instead, the enterprise too often drags out a painful existence for a few months or a few years, eats up the owner's capital, and at the end leaves him a poorer, but not always a wiser, man.

Financing and Accounting

Poor financing is apt to be combined with poor accounting; and in that case the unfortunate owner cannot enjoy even the empty satisfaction of a post-mortem diagnosis.

This brings up a question on which there has been much confusion of thought—the question as to the dividing line between the subject of financing and the subject of accounting. It is not purely an academic question, for in many business concerns the head of the accounting department and the head of the financial department are continually treading on each other's toes. Or, a still worse thing happens; the two offices are combined under the management of one person.

There is undoubtedly a twilight zone between the two subjects. When we come to discuss rates of depreciation, sinking fund requirements, valuation of good-will, and the like, we shall be in constant danger of trespassing into accounting territory; while, on the other hand, our friends the accountants, especially public accountants, have not hesitated to make many bold forays into financial fields. Frequently they are called upon to advise their clients as to securing bank loans, the proper types of bonds and shares to issue, the proper investment of capital funds, the declaration of dividends, and so on. However, bankers, treasurers of corporations, and finance committees are becoming more and more successful in repelling these incursions, thus restricting the accountant to his proper activities.

We need not enter into the technicalities of the friendly controversy. A broad distinction, however, between the two fields of work and study may easily be made. Accounting, properly speaking, deals with recording and analyzing results that have been achieved; and its growing value and popularity is due to the general recognition that the conclusions drawn by skilled accountants may profitably be used as a foundation for future action.

Financing, on the other hand, deals not with recording and analyzing but with getting positive results; how to raise money for various business enterprises; what securities to issue; to whom they should be sold; and how to use the proceeds to the best advantage for the promotion of the business. These are some of the typical problems clearly outside the scope of accounting which are discussed in this volume.

Two sister subjects in the field of finance are investing and banking. Investing deals with the process of supplying capital to business and public undertakings for their permanent use, that is, as original investments or for long-term loans. Banking deals with the process of supplying capital to these enterprises for their temporary use, that is, for short-term loans exclusively. Both of these processes are referred to frequently but they are of so much importance that they will be treated separately. (See Chapters V, VI.) It may be noted that both investing and banking deal with *supplying* credit, while financing deals with *obtaining* and *using* credit. The same problem is involved in both but is treated from different points of view.

Public Financing and Business Financing

Another cognate subject, which is, however, outside the scope of this book, is public financing, which deals with the securing and handling of money and credit for governments—national, state, and municipal.

Public financing has been much studied and written about; many valuable books have been published on such subjects as taxation, governmental loans and their repayment, regulation of governmental expenditures, and the like. Business financing, on the other hand, has been surprisingly neglected; there are only about a dozen books and a few magazine articles devoted wholly to this subject, though, of course, a great deal of valuable information may be gleaned from miscellaneous publications.

Yet the relative importance of the two subjects—public financing and business financing—seems to be in inverse ratio to the amount of study that has been given to each.

In 1912, according to the United States Census, the total value of all the property existing in the United States was approximately \$187,000,000,000, of which \$12,000,000,000 or 7% was exempt from taxation and \$175,000,000,000 or 93% was taxable. Making reasonable allowances for the property of religious, educational, and philanthropic institutions in the tax-exempted classification, there remains only 3% to 5% of the wealth of the United States that is directly owned by national, state, and municipal governments. Against this there is 93% owned and managed by individuals, firms, or corporations. On its face the comparison indicates that the neglected subject of business financing is worthy of thorough and careful study.

There are probably two chief reasons, both inadequate, why business financing has been comparatively overlooked. One is the false notion, prevalent until recent years, that private business is a simple activity unworthy of serious consideration by intellectual men. Another reason is that data concerning methods of business financing methods are not conveniently assembled in volumes or in reports or statistics, but must be gathered, in large part, at first hand from active business men and from general business experience. As time

goes on, the subject will doubtless be more fully investigated and more information will be made available.

It will become evident as we proceed that financing is related also to other business subjects, such as production, selling, organization, etc.; but there is no confusion in its relation to these subjects and no necessity for explanation.

Simplicity of Business Finance

It is popularly supposed that many difficulties are encountered in solving the problems of business finance. One writer even has defined the science of business finance as "the modern black art," as if it were something mysterious and uncanny. Yet, whatever may be said of the difficulties pertaining to actual practice, the essential principles of business finance are simple and can be readily understood by anyone. This can be illustrated by the close analogy existing between the financial problems of the business enterprise and the financial problems encountered by the ordinary individual in his daily life.

The individual possesses both tangible and intangible assets. He has money, tools, land, and other material things. Also, he possesses health, skill, knowledge, and other assets that are intangible. Business divides its assets into things tangible and intangible in the same way; its plant, equipment, stock, and cash being tangible assets; while its good-will, trade name, patents, and copyrights are intangible assets.

The individual has his capital and his income and from these he must take his expenditures: first, to keep himself in condition to do business; second, to increase his productive and consequently his earning power; third, to reserve a portion of his income. He knows the laws of thrift and prudence, and knows that if he will obey them he will prosper.

It will be shown that precisely the same kind of wisdom and foresight is required to invest properly the capital and

income of a great business so that it shall continue to grow and prosper and shall not be short of funds and credit should an evil day unfortunately come. The business, great or small, that does not keep its expenditures within its income is as certain to come to grief as the individual who spends more than he earns.

An individual should, from time to time, take an inventory of his resources and liabilities, physical, intellectual, and spiritual as well as material, and thus determine whether he is becoming richer or poorer. In like manner, every business should, at regular intervals, take an inventory, balance all accounts, subtract losses and add gains, and thus ascertain whether it is gaining ground or falling behind.

Borrowing Money

All our greater businesses are conducted largely with borrowed money; and in this matter we may carry our analogy with the individual yet further. It is well to remember, however, that in borrowing for a legitimate purpose we are not engaged in that shiftless borrowing condemned by sages and moralists. Polonius said:

Neither a borrower nor a lender be;
For loan oft loses both itself and friend
And borrowing dulls the edge of husbandry.

But this was not said in reference to borrowing or lending money for profitable business purposes.

When a young man makes a long-term loan and pays interest on it in order that he may take a college course or prepare for a profession, he is not acting foolishly but wisely; for the money will bring him a wealth of skill and knowledge that will enable him to repay both loan and interest, and during his life the transaction will increase both his usefulness to society and his earning power. In the same way, when a

business concern can borrow money to enlarge its plant, make needed improvements, develop the enterprise, and increase its profits, such borrowing is not only permissible but commendable.

There are, however, some obvious limitations which will at once be recognized. No individual should borrow money unless it can be used to advantage and repaid promptly when it falls due. For this reason, short-term borrowing is usually not good business for either an individual or a business unless it is to "swing" some transaction that can be quickly completed, or to tide over a brief stringency.

Permanent and Transient Investments

We can carry our analogy still further. All business assets belong in one or the other of two classes: those that are fixed and permanent, and those that are temporary and designed to be converted into cash within a short time; the first class is known as "fixed assets" and the second as "working assets." In every business there should be a proper proportion between the amount invested in fixed assets and the amount reserved for working assets.

Both the individual and the business concern often fail to observe the necessary proportions. Not infrequently an agriculturist buys more land than he can profitably work and we have a "land poor" farmer. Many country merchants buy more stock than they can immediately sell. The less salable portion becomes shopworn and, as a consequence of this needless tying up of money, they are without funds to replace the more salable articles. Many businesses, both great and small, have met disaster because the necessary amount of working capital was not correctly estimated, too much being invested in plant and equipment and an insufficient amount being left to conduct the business.

It is always advisable to possess an emergency fund or

some quickly convertible assets. From time to time, opportunities offer which can only be taken advantage of by the possessor of ready cash, and when this propitious chance occurs the forehanded business man can act quickly and profitably.

Application of Income

Both the individual and the business concern possess a certain income from which living or supporting expenses must be drawn; therefore, to both the individual and the business concern comes the question of how much of the income may properly be utilized for non-paying purposes, such as pleasure in the case of the individual and dividends in the case of the business concern.

At the beginning of each year the individual should estimate his needs. The business establishment should, in like manner, determine what amount of earnings should be set aside for a reserve, what should be applied to each department for maintenance, depreciation, etc., and whether an increase or curtailment of income may be expected. Item by item, this estimate should be scrutinized to learn where an outlay may be profitably curtailed, or where an outlay may be made for ultimate benefit. Such a proceeding is a practical method of planning finances; it can, and should be, consistently followed.

Elementary Rules of Financing

The following elementary rules of business finance apply alike to individuals and to the largest enterprises; the remainder of this work consists practically of the application of these general rules to various business problems.

1. Study and utilize all sources of capital, including earning power and credit.

2. Do not be afraid to borrow for legitimate business development when you can earn profits and repay the loan when due.
3. Do not dissipate capital on side lines and outside investments.
4. Systematically accumulate assets, both tangible and intangible.
5. Always keep available sufficient cash and convertible assets to meet emergencies and to seize special opportunities.
6. Use income sparingly for living expenses and pleasure, but freely for business maintenance and development.
7. Use foresight—which is the cardinal virtue in all financial operations; make budgets to govern all expenditures.

These are the prudent, indisputable rules for sensible financing. They have been preached and proven over and over again for many centuries past. The wisdom which these homely rules embody applies just as truly to the business of the Standard Oil Company and the United States Steel Corporation as to the affairs of John Smith. A man who can grasp these principles, hold them continually before his eyes, and apply them intelligently, is bound to handle his finances wisely both in his business and in his private life.

However, simple as they are, to apply these fundamental principles to all the complex situations which arise in modern business is no easy task. Sound financing calls for clear thinking and a wide range of knowledge.

CHAPTER II

FORMS OF BUSINESS ENTERPRISES

Basic Types of Business Organization

Throughout the world, wherever business enterprises are carried on, there are to be found three basic forms in which the ownership of these enterprises is held.

1. The individual owning outright his own business and usually managing it himself without much co-operation or assistance.
2. A group of owners, working together under some form of partnership agreement.
3. The impersonal owner—the corporation—standing between the business and the individuals who have various kinds and degrees of claims upon the business.

These three basic forms are combined and recombined in many different ways under the laws and customs of the various commercial countries, but analysis always reveals one or the other of the three forms predominating.

This is shown by the short description, which has been added, of three other forms of business organization not often used but of interest, as showing how difficult it is to get away from the basic types. These are the limited partnership, the joint-stock company, and the association under deed of trust.

The first two of these basic forms—sole proprietorship and partnership—represent the personal relationship of a man or a group of men to the business; but the third form, which is a comparatively modern invention, separates the owner or

owners from the business and brings into being an impersonal, intangible thing—a corporation—in which the nominal ownership is vested.

It has been pointed out by writers on economics that there are three elements that must be distributed under any form of ownership; these three elements are risk, income, and management. In the individual proprietorship the three are centered in one man who risks his own capital, undertakes the management, and receives all the income. Under the partnership form, the partners as a body, like the individual owner, undertake the risk and management and receive the income; but among themselves there may be an infinite number of combinations. One partner, for instance, may supply all of the capital; another may supply the management; and they may divide the income in any manner agreed upon. Under the corporate form the risk is taken by the various creditors and shareholders who supply capital under the conditions that have been agreed upon. These creditors and shareholders divide the income in rough proportion to their risk. The management, however, is not necessarily retained in the hands of the people who contribute the capital, but may be turned over to directors and officers who are not personally large shareholders. The tendency has plainly been to separate the supplying of capital for the business and the management of the capital so that they need not necessarily be joined in one man or even in a small group of men.

Sole Proprietorship

The first of the three basic forms of business organization—the sole proprietorship—is the simplest and is even yet the most numerous. Small shops, farms, professional activities, and the like, are usually owned and conducted by one man. The owner does not separate his ownership of the business from his management of it; he does not even separate the

ordinary management of his business affairs and the management of his personal affairs. He, himself, is the business and the business is a part of him.

The simplicity of this form does not necessarily imply, however, that it is applicable only to a small business. Many men of great wealth could properly regard the investment and management of their funds as itself a business, for this work alone sometimes requires the services of a force of assistants, bookkeepers, and clerks. Then, again, an individual may embark upon a business enterprise which grows rapidly from year to year and becomes very extensive; yet the original proprietor may continue to own and direct it all. This was the case, for instance, up to a few years ago with the great department stores in Philadelphia and New York which were personally owned and managed by Mr. John Wanamaker. However, it usually happens that a business which is becoming large and prosperous finds the single proprietorship undesirable.

The sole proprietorship has a real advantage in the ease with which a business may be started in this form, and a slight economy due to the absence of all legal agreements. A forceful man can often, by reason of his freedom from any restraint, make rapid growth under this form. A young man who starts his own business in his own name learns business management as the business grows, masters the difficulties of financial problems as he solves them, and becomes an all-round business man, with initiative, ability, and resourcefulness, by the natural evolution incident to his situation. Many of the biggest businesses and very many of the biggest business men in this country have developed along the lines of sole proprietorship.

Its chief disadvantages are three in number. First, the capital of the business is limited to whatever the owner possesses or can borrow. Some kinds of businesses, if they grow

at all, will finance themselves, so that there will never be need for any more capital than was devoted to the business at the start; but the great majority of business concerns which are expanding require fresh capital.

A second and even more serious disadvantage is the strict limitation on the management of the business. The owner must depend for all executive work either solely upon his own efforts or in part upon the efforts of men whom he engages at a fixed salary. Men of real executive ability ordinarily prefer to go with concerns in which they themselves have an interest in the business. If the individual owner wishes to secure the services of these men, the salaries he pays must be exceptionally high. To refer again to the case of John Wanamaker, it is reported that when he was getting started in Philadelphia, there were at least a dozen of his employees who were drawing much larger incomes from the business than was the proprietor himself.

The third disadvantage, as compared at least with the corporation, is the ever-present personal liability of the owner for all the debts of his business. He cannot legally separate his personal property from that devoted to his business.

The Partnership

Fundamentally, there is no essential difference between the sole proprietorship and the partnership, except that in the second case a group of owners take the place of the individual owner. There may be any number of partners and among themselves they may have many different forms of agreement. The agreement must be, of course, between parties competent to contract. Partners are not necessarily equal, by any means, in respect to their investment of capital or as to their division of the income. Sometimes one partner receives a larger proportion of the income than corresponds to his investment of capital in order to compensate him for a special contribution

that he may be in position to make to the business, such as valuable experience or connections, or unusual business ability. A partner may not desire to have much capital in the business or even to be known as in any way interested, in which case he may by agreement become a "dormant" or "sleeping" partner. Again, he may desire to limit his own liability to the amount which he invests, in which case he may become a "limited" partner.

There are certain forms of partnerships which are used for special or temporary purposes, such as the "syndicate," the "joint adventure," etc., but these are details that involve us in many technical questions and lead us outside the scope of this volume. In all these various forms, however, the personal relationship of the owner of the capital to the management of the business is a strong element. It may be hidden or modified in part, but it is never absent.

Because of the personal element involved, the partnership is regarded as the proper form in which to organize such professional activities as those of lawyers, accountants, and engineers. In all these cases it may be necessary to bring together in one organization considerable capital and the talents of many different men. The product of this organization, however, is not some material thing, but a direct personal service; hence, the personal liability and personal relationship, which are characteristic of the partnership form, are desirable and should be retained. There are other lines of business in which it is desired to avoid the legal regulation which is applied to corporations, and for this reason the partnership form is preferred. This is particularly true of the banking business. Most concerns engaged in buying and selling securities, in underwriting, and the like, are not incorporated, but are organized as partnerships. There are a few large trading and manufacturing enterprises in the partnership form. Until recently, Arbuckle Brothers and the Baldwin Locomotive

Works were still conducted as partnerships, and this is even yet true of Rogers, Peet and Company, of New York.

Disadvantages of the Partnership

Of the three disadvantages applicable to the individual proprietorship, only one does not apply to the partnership. There is very little difficulty under the partnership form in attracting high-priced business talent. On the contrary, in this one respect the partnership is probably superior to both the other basic forms of enterprise. The other two disadvantages of individual proprietorship—the limitation on command of capital and the personal liability for all business obligations—are, however, shared by the partnership.

By reason of the personal character of the relationship between each of the owners and the business, it is highly undesirable that anyone should be included in a partnership unless he is personally acceptable and able. As all of the partners, except dormant or limited partners, have equal rights in the control of the business, and as any one of them may bind the entire firm by his acts or contracts, the consequences of bringing in an incompetent partner may easily be very serious. As compared with a corporation, this introduces a serious handicap in searching for fresh capital with which to develop the business. It is necessary not merely to find one man with capital and another man with brains to help manage it, but to find one man who has both the capital and the brains, who is at the same time willing to devote time, money, and thought to the enterprise, and whose personality is such as to insure harmonious relations with the existing partners.

The other disadvantage, namely, the personal liability of each part owner, is even more serious in the partnership than in the sole proprietorship. In the case of the individual proprietor, he can suffer only through his own misfortunes or errors; the partner, however, may suddenly find himself face

to face with heavy loss due to the bad fortune or errors of any of his partners. His own personal property (except under one of the special forms of agreement above referred to) belongs to the business and to the creditors of the business until the last debt has been paid. If one of his partners proves dishonest or treacherous, he may be called upon to foot the bill—and not merely to the extent of his previous investment in the business, but to the extent of all of his personal holdings. It is for this reason that a partnership agreement is so weighty a matter. Moreover, on the death or withdrawal of any of the partners, if an agreement cannot be reached with the retiring partner or with the estate, it may be necessary to go through all the trouble of suit in equity for an accounting and wind up the business.

In the face of these disadvantages it is not surprising that very few business concerns, outside the special classes mentioned, have retained the partnership form. It is becoming every year relatively of less and less consequence.

The Corporation

The corporation is quite distinct from the sole proprietorship and the partnership. The capital is supplied by a small or large group of people called shareholders, or stockholders. The business is usually managed by a group of officers and directors elected by the shareholders. The shareholders have no liability for the debts of the corporation beyond the amount which they have contributed as capital. Owing to the possibility of dividing the capital up into shares of comparatively small amount, funds may be raised from the general public by putting these shares on the market; and it is much easier to finance a business of great magnitude in this way than through either individual ownership or through a partnership, in which there are necessarily only a limited number of people.

The business is thus managed by only a part of the people

who supply the capital. The corporation itself is regarded as a distinct and separate entity, capable of doing business by itself; the corporation may sue, may be sued by, and may contract with its own members, as well as with outsiders. The officers and directors conduct these operations in the corporate name.

The corporate form is used for social and governmental, as well as for business, organizations. Towns, villages, and cities are conducted as corporations. Corporations for governmental purposes are called public corporations; corporations for business and social purposes, private corporations.

Religious, educational, charitable, and social organizations are usually incorporated without capital stock and are known as membership corporations. When corporate action is taken, each member has one vote and no more. Mutual insurance companies and stock exchanges are among the more important of the non-stock corporations.

All corporations to conduct business for profit have a capital stock divided into shares, usually of like amount, which are evidenced by transferable certificates of stock. The holders of these certificates are termed stockholders. Each share of stock usually entitles its owner to one vote in stockholders' meetings, and a majority of the shares elect the directors and control the policy of the company. When profits are to be divided, they are distributed among the stockholders in proportion to the number of shares they own.

Limited Partnerships

In an effort to overcome the disadvantages incident to the partnership relation, many enterprises, especially in Great Britain and the British colonies, have been organized as "joint-stock" companies, which may be briefly defined as a form of limited partnership. In the United States, as we shall see, this movement, though of some importance, has not gone

very far because of the superior advantages of the corporate form.

A limited partnership may only be formed under special laws. It differs from an ordinary partnership in that one or more of its partners are silent or inactive; they share in the profits but take no part in the management of the business. The liability of these partners is limited to the amount actually invested by them in the business. These partners whose liability is limited are called special partners in contradistinction to the other general partners. To secure this restricted liability it is necessary to comply closely with the statutory provisions. The procedure necessary to form a limited partnership is almost as formal as the incorporation of a stock company, and failure to observe the required formalities may result in making the special partners liable as general partners. Sometimes it is attempted to secure the benefits of this limited liability without complying with the state law. In such case, the individual who invests his money keeps the matter secret and is known as a dormant or "sleeping" partner. If the arrangement is discovered, he would be liable in exactly the same way and to the same extent as an active partner.

Joint-Stock Companies

A joint-stock company is a partnership with its capital divided into transferable shares. Except in the State of New York, such a company may be formed simply by agreement. In New York special statutes provide for an organization similar to a corporation, and the formation of such associations is prohibited except as provided by the statutes. The courts in New York define these organizations as being partnerships with some of the powers of a corporation. In New York these joint-stock companies may sue or be sued in the name of the president or treasurer, and the individual members may not be sued until it is shown that the claim cannot

be collected from the company. Several of the leading express companies are organized under the New York Joint-Stock Company Law, and in these cases the arrangement seems to work very satisfactorily. In other states the joint-stock company form is very rarely used for the following reasons:

1. Members of the company are individually liable for its entire obligations.
2. While the company can do business under its company name, it cannot hold real estate and it is necessary that any real property be held by some agent or officer as trustee for the company.
3. The joint-stock company must bring suit in the names of all the members, and, if it is sued, only those members who are served with process can be held.

There are cases where the danger of partnership liability is too remote to trouble the members, and in such cases the joint-stock company secures the same advantage of stock and transferable stock certificates as does the corporation. The form could not be used where stock is to be sold to investors as these would not risk the partnership liability involved. Practically, the joint-stock organization is rarely used in this country. In Great Britain and the British colonies, it is quite common. From a financial standpoint the British joint-stock company is practically the same as the American corporation. The words "company" or "corporation" will hereafter be used interchangeably and refer to either.

Associations Under Deeds of Trust

Various experiments have been tried at different times in the way of carrying on business through trustees. It was long ago decided in England that the actual owners of the property could not be held liable as partners if the property was in trust and the business carried on by trustees.

The Standard Oil Company, the Sugar Trust, and the Bay State Gas Company in this country were all organized as trusts. A board of trustees took over the stock of the constituent companies and issued trust certificates to the owners. Thereafter, until the courts declared such organizations illegal, these boards of trustees dominated their respective industries. The courts decided that trusts of this nature were illegal, not because of any objection to their form of organization, but because their chief object was to restrict competition.

When the trust form was forbidden to these monopolies, they resorted to the holding corporation, but the name "trust" persisted and is still used to designate the great monopolistic corporations. It is misleading and has caused considerable unjust prejudice on the part of the public against this method of doing business.

The trust form of business association is used to a limited extent in Massachusetts. Up to 1912 the law in that state made no provision for corporations to deal in real estate, and consequently a large number of real estate trusts under the name of "voluntary associations" came into existence. They have increased until they now own not less than \$250,000,000 in real property. Of late years this form of organization has extended to a limited degree into other lines of business activity and may become a popular form.

The characteristic features of these voluntary associations are as follows:

1. A deed or declaration of trust, drawn up to define the rights and powers of the trustees and the shareholders.
2. Two or more trustees who are authorized to take over and manage the capital, business, or property supplied by the shareholders.

3. Shareholders who receive transferable certificates representing their respective interests in the profits and in the property on dissolution.
4. Provisions for division of profits, appointment of trustees to fill vacancies, and for dissolution at termination of the trust.

It is usual to provide in the deed of trust that no liability is to attach to the shareholders or trustees.

The Commissioner of Corporations of Massachusetts in closing his report summarizes the advantages afforded by these voluntary associations as follows:*

1. The experience of twenty-five years shows that they furnish a convenient, safe, and unobjectionable form of co-operation, ownership, and management.
2. Their form of management is more flexible, more economical, and more convenient than that of a corporation. Trustees can do business with more ease and rapidity than a board of directors.
3. In particular they afford a convenient form for combining capital for the development and improvement of real estate, as the form of organization insures a continuity of management and control that specially appeals to investors in real estate, and which cannot be secured by a corporation on account of the change of officers each year. Trustees are not changed as frequently as are directors of a corporation.

Business Organization Under the Latin Law

The principal forms of business associations in France are: (1) the ordinary partnership with a firm name (*société en nom collectif*); (2) the limited partnership (*société en commandite*); (3) the joint-stock company (*société anonyme*).

The partnership is much the same as under English and

*Report of Massachusetts Tax Commissioners upon Voluntary Associations, January 17, 1912. See also Sears on "Effective Substitutes for Incorporation," and Chanler on "Express Trusts."

American law except that the personal element is even more strongly accentuated; for instance, it would be fraud to insert in the name of the firm the proper names of any persons not actually connected with the firm. The partners are considered to have given each other the right to manage one for the other, and to bind the firm by their signatures.

The so-called *société anonyme* resembles the English joint-stock company more closely than the American corporation. The separate existence of the association, apart from the individuals who make it up, is not so much insisted upon as in this country. The directors must be chosen from among the shareholders. In France the directors must draw up a brief statement every half-year showing the condition of the company as regards assets and liabilities. In all corporations it is necessary to deduct not less than 5% from the net profits of each year for the purpose of forming a reserve fund. This deduction need not be continued after the reserve fund has come to exceed 10% of the capital of the company.

In general, without attempting to enter into legal technicalities, the customary character of business associations is the same throughout the Latin countries, including France, Spain, Portugal, Italy, Belgium, and practically all of South America. In all these countries the *société anonyme* is the form of association which corresponds to our corporation or joint-stock company.

Business Organization Under the German Law

There are various forms of associations under German law of which the stock company (*Aktiengesellschaft*), and the limited liability company (*Gesellschaft mit beschränkter Haftung*, usually abbreviated *m.b.H.*) are the two most popular forms.

The stock company may be regarded as, for most practical purposes, equivalent to a corporation or joint-stock company

under English and American law. It usually has both a board of directors (*Vorstand*) and a board of managers (*Aufsichtsrat*), but does not necessarily possess a president, secretary, and treasurer. Executive power, in other words, is lodged in the board and not in individual officers.

The German limited liability company has been described as a cross between an American corporation and a partnership. "In contemplation of German law, it is an artificial person or *juristische Person*, and has an existence of its own separate and distinct from that of its founders and shareholders; and is therefore a body corporate. This corporate form is much simpler than the *Aktiengesellschaft* or stock company. Its capital is not divided into shares and no certificates of stock are issued. Individual interests or holdings in the company may be transferred in whole or in part by notarial or judiciary act.*

This form of association is used chiefly for small companies in which only a few persons are interested. The management is usually determined by agreement among the various persons interested, much as in an ordinary partnership, though in the larger companies of this type there may be a board of control.

*Report on the Commercial Laws of England, Scotland, Germany, and France, by Archibald J. Wolfe in collaboration with Edwin M. Borchard, issued by the Bureau of Foreign and Domestic Commerce, Washington, D. C., 1915. Much of the information contained in the preceding section also is abstracted from this report.

CHAPTER III

THE CORPORATION

Origin of Corporations

The modern corporation did not suddenly spring into being as a device for overcoming the obstacles of previous forms of business enterprises. It has been slowly and painfully developing for centuries, and in its present form is a composite of the ideas and the experience of many different races and generations of men.

On one side, the business corporation is closely related to the municipal and religious corporation. The jurists of the early middle ages conceived—or rather adapted from Roman law—the idea of the church as a legal entity, distinct from any of its officers or ministers. It was clear that the endowments, for instance, which were given to bishops and abbots were not intended for their personal enjoyment nor to be disposed of as they saw fit. It was desirable that the funds should be entrusted to an owner that would exist year after year and generation after generation, irrespective of human frailties or vicissitudes. Out of this need for permanence and for impersonality in holding religious property, grew the perfected idea of the church itself and of other religious and charitable organizations existing as separate entities or “corporations.” It was an easy step, when a similar need arose in business undertakings, to transfer this conception from religious organizations to business organizations.

During the last three centuries, the corporation has grown, both in Europe and in the United States, along parallel lines of development. The result attained is not exactly the same, for there are many technical points of difference between the

German *Gesellschaft mit beschränkter Haftung*, the French *société anonyme*, the English "joint-stock company" and the American "corporation," but these points of difference are of no great importance compared with the central fact that in all these, and in all other commercial countries as well, there has come to exist a certain type of business association, the essential features of which are:

1. Little or no direct personal relation among proprietors or between the proprietors and the business; such relations as do exist are on the impersonal basis of capital invested.
2. Control and management by elected representatives acting in trust for the proprietors.
3. Liability of proprietors limited to their investment or to some fixed amount proportioned to their investment.

Fiction of Corporate Entity

Both the Continental courts and the English courts have tended always to regard the corporation or company as if it were a group of individuals, while in this country the tendency has been to follow strictly Chief Justice Marshall's famous definition in the Dartmouth College case in 1819, wherein he spoke of the corporation as "an artificial being, invisible, intangible, and existing only in contemplation of the law." The logical simplicity of this view appeals strongly to the legal mind, and many beautiful bits of fine-spun reasoning based upon it are to be found in the records of our courts. But unfortunately, it happens to be far removed from the facts of every-day business life. We all know that in practice the corporation has no existence and no interests apart from the existence and interests of its shareholders, creditors, and officers. In an ideal world, possibly, men would devote them-

selves to building up a business corporation for its own sake, just as many men have devoted themselves to building up religious and governmental corporations, and in that case there would be some solid basis for the lawyer's line of reasoning. However, in our work-a-day world, the reverse is more often true; the corporation may easily prove a convenient shield for the men back of it who are intent upon actions and policies for which they would not care to accept, as individuals, the full responsibility.

The fiction of corporate entity favors this species of misuse. It erects an obstacle—an "invisible, intangible," but effective obstacle—between the wrongdoer and his victim.

Recognizing this abuse, the courts of this country have become more and more inclined in recent years to tear aside the corporate mask and look for the men and the motives behind corporate actions. This is true at least of courts of equity. Nevertheless, we are still tangled and blocked at every step by the thousands of precedents consisting of decisions based upon the fundamental idea of the corporation as a thing distinct from the men who compose it.

Grant of Powers by the State

The powers of a corporation are derived from the charter granted it by the state and these powers are limited by the law in some respects. A corporation has no power to do anything not expressly mentioned in its charter or necessary to carry out some purpose which is expressly mentioned by its charter.

Before the general incorporation acts were passed, the corporation had to secure its life and its grant of powers by special application and special act of the legislative or sovereign authority. Since then, the application has become a matter of form only. There is no discretion in the executive authority to refuse any request for a charter which conforms

to a few set forms and regulations. Any citizen has as much right as any other to organize a corporation without asking a favor from any man or any governmental body.

Special Charters

Special charters are still sometimes applied for and obtained, but they are not in high favor for several reasons. First, of all, it frequently requires political influence and pressure to secure them; second, unless there are some marked peculiarities of the law, there is ordinarily no reason to prefer a special charter over the ordinary charter obtained under a general enabling act; third, a special charter is always more or less an uncertain thing because it has not been given authoritative interpretation by the courts, whereas the charter obtained under a general act can be framed with an eye to previous decisions and can thus be cleared of unexpected legal pitfalls.

A feature of public utility corporations in Great Britain is the fact that each company is organized and governed by a special act. These acts, however, are to a considerable extent standardized through uniform clauses and model forms that have been adopted by the Board of Trade. In general, any company in Great Britain which exercises rights of eminent domain or other exceptional rights is likely to ask for a special charter. However, numerous small gas and water companies and other public utilities are operated without special parliamentary authority, and are chartered under the general enabling law known as the "Companies Consolidation Act" of 1908.

An ordinary charter in the United States is in the form of an application to the Secretary of State or other proper authority for permission to incorporate; as soon as a governmental official has received, approved, and filed this application, it becomes the charter—we might call it the constitution

—of the corporation. The information which it contains is usually the following:

1. The name of the corporation.
2. The purposes for which it is formed.
3. The amount and classes of corporate stock.
4. The location of the principal business office.
5. The period of existence of the corporation which is usually unlimited or perpetual.
6. The names and addresses of the incorporators.

The Corporate Name

It is provided in several states that the corporate name must include the word "Company" or must be followed by some such word as "Incorporated" or "Limited," the purpose being to show in the title itself that the enterprise is incorporated. It is in most states forbidden to take a name which has been already utilized by some previously existing corporation, or to take a name which is so close as to be misleading. Corporations which have acquired a great deal of good-will value in connection with their names, depend, however, chiefly upon the common or statutory laws against unfair competition to protect them against imitation or misuse of their names.

The Corporate Purposes

The purpose for which a corporation is formed should be fully and clearly stated; it is customary to add one or two paragraphs of a general nature which give the corporation power "to do any and all other acts and things and to exercise any and all other powers which a copartnership or natural person could do and exercise and which now or hereafter may be authorized by law." It is not always convenient, although there are usually no legal difficulties, to amend the statement of purposes in a charter; for this reason liberality and fulness in stating them in the first place are desirable. A great many

useful forms for stating the purposes of corporations engaged in various lines of business are easily available through the standard legal manuals.

Classes of Stock

The statement as to the amount and nature of the various classes of stock is a section of the charter which is customarily amended from time to time in case changes in the company's capitalization are made. Sometimes the original statement is intended simply as a "blind." For instance, the certificate of incorporation of the United States Steel Corporation which was filed in the office of the Secretary of State of New Jersey on February 23, 1901, showed a capitalization of \$3,000. On April 1, 1901 the certificate was amended and the capitalization was changed to \$1,100,000,000—one-half common and one-half preferred.

The Principal Business Office

The principal business office is not necessarily the office at which most of the business of the corporation is transacted, but is the office at which legal papers may be served and certain legal business transacted. Many of the large corporations of the United States having their headquarters in New York, are incorporated in New Jersey, Delaware, or some other state. In that case their "principal business office" is likely to consist of a meeting place loaned to them from time to time in the office of some firm of lawyers or some trust company; the name of the company is usually posted somewhere so that no one may fail to find the company or its representative if he so desires. At the entrance to the office of the Corporation Trust Company in Jersey City, there is a directory of several hundred corporations all of which have their "principal business office" with the Corporation Trust Company.

It would not be advisable to enter here into other details as to the provisions of the charter and the methods of incorporating. The reader who desires more detailed information can easily obtain it by consulting the statutes of his own state or by referring his inquiries to a capable lawyer.

Operation in Other Jurisdictions

After a corporation has obtained a charter, it must still face the question of ascertaining its rights and powers outside of its home state if it desires to do an interstate or an international business. Strictly speaking, a charter does not in itself create an existence that can be recognized outside the state or nation which gives the charter. The "domicile" of the corporation, as the lawyers explain it, must be within its home jurisdiction. In the famous case of the *Bank of Augusta v. Earle*, decided in 1839, the United States Supreme Court said, speaking of incorporation: "It exists only in the contemplation of the law and by virtue of the law, and where that law ceases to operate and is no longer obligatory, the company can have no existence." If this theory were always literally and fully applied, it would be necessary to create a new corporation for every state in which an enterprise is being conducted. To avoid so unworkable a conclusion, Chief Justice Story brought into play the doctrine of interstate and international comity. "The laws of one state," he said, "have no binding force, it is true, in any other state but they should be recognized and so far as possible applied as a matter of courtesy." The comments of the English barrister, E. Hilton Young, on the doctrines of corporate entity and of interstate comity in American jurisprudence, are amusing and well founded. "No sooner is it admitted," he says, "that juristic persons have no existence except in the contemplation of the law which created them, than a fiction is invented to enable them to claim a universal existence. A fictitious disability is

overcome by a fictitious recognition, and thus one fiction cancels out the other."

Operation in Foreign Countries

The tendency of modern thought and practice is toward giving recognition in all civilized countries to commercial associations formed under the laws of other countries. In England the "Companies Consolidation Act" of 1908 requires certain formalities of foreign companies which carry on business in the United Kingdom; by complying with these formalities, any such company may open a branch office and operate on equal terms with English companies. Conventions have been made by England with France, Belgium, Italy, Germany, Spain, Greece, Tunis, Austria, and Russia for reciprocal admission of commercial associations to civil rights. Since early in the sixteenth century, it has been agreed that "a foreign corporation can appear in its corporate character before the English courts and be regarded as a person by the laws of England."

In nearly all the Latin countries, not only of Europe but also of South America, it is easy for a foreign corporation to obtain rights equivalent to those of a domestic corporation by the same simple process of registration. Among European countries, Russia and Austria are reported to be most hostile toward foreign corporations, while Italy and England assume an especially liberal attitude.

A fair illustration of international practice is the current law of Argentina with regard to foreign corporations, which is as follows:

Article I.—Corporations organized under the laws of foreign countries may do business in the nation without previously acquiring the authority of the government providing they give proof before competent magistrates of having been constituted in accordance with the law of

their respective countries and register the statutes and other documents appertaining thereto with the Public Registrar of trade.

Article II.—The provisions of the preceding article shall from the promulgation of this act be in force for the corporations whose country of origin admits reciprocity.

One question that arises in connection with all foreign corporations is: When may it be said to be “doing business” within a given jurisdiction? The customary rule is to the effect that isolated transactions may be carried on by any corporation without its having been previously registered and licensed, just as by any natural person. But in case a foreign corporation is conducting a regular business and especially if it is maintaining a branch office, then it must be registered in order to make its contracts enforceable. There is, of course, no fixity about this rule, and it is often a delicate question to tell whether a corporation is actually doing business within a given jurisdiction or not.

Internal Regulations and By-Laws

A corporation, having obtained its charter or fundamental constitution from the state, is expected to draw up and enforce its own internal regulations. It usually at once adopts written by-laws as its internal code. Thousands upon thousands of corporations, having adopted excellent by-laws, thereafter disregard them as completely as if they had never existed. The larger concerns, however, in connection with which more formality is necessary, and the smaller concerns in which there is current or probable friction among the members of the board, quickly discover that the by-laws are intended to be observed carefully and that by so doing much useless trouble may be averted.

The statutes of the State of California give a statement of

the subjects which should be covered in the by-laws of a corporation, as follows :

1. The time, place, and manner of calling and conducting meetings.
2. The number of stockholders constituting a quorum.
3. Mode of voting by proxy.
4. The qualifications and duties of directors, and also the time and method of their annual election.
5. The qualifications and duties of officers.
6. The manner of election and tenure of office of all officers other than the directors.
7. Suitable penalties for violation of the by-laws.

Among the other subjects which are not essential, but are frequently treated, are:

8. Electing directors to fill vacancies up to the next succeeding meeting of the stockholders.
9. Order of business at directors' meetings.
10. Compensation of directors and officers.
11. Organization of standing committees of the board of directors.

Rights and Duties of Shareholders

The men who took part in the early English joint-stock enterprises—such as trading expeditions to the Indies or Americas—were appropriately known as “adventurers.” The title would not be inappropriate in many cases if it were applied to present-day shareholders in corporations. The average shareholder in a large corporation has the privilege of paying out money in return for which he receives his holdings of stock, and has the right to his proportionate share of whatever profits are distributed. He has also the right—which the small shareholder seldom exercises—of voting for directors who are supposed to represent him. That duty having once

been performed, he ceases to be a factor of much importance in the management of the company; in fact, as a shareholder, he probably does nothing except hopefully wait for and gratefully receive whatever dividends the board of directors sees fit to allot to him.

The American Practice

In American practice the average shareholder, even of smaller corporations, unless he happens to be also a director or other officer, is not only helpless, but uninformed. He may be furnished, if it so pleases the directors, with a fairly complete annual report; the more enlightened corporations even send out monthly or quarterly statements of earnings. He does not, however, meet his directors and officers face to face unless as a purely personal or exceptional event. He does not ask questions; he has no representative to dig up information for him; he is completely in the dark as to the plans formulated by the directors and even as to the real results and prospects of his corporation. There are, of course, some exceptional cases. A few stockholders occasionally drift into the annual meetings of large corporations, but these meetings are of so formal a character that the stockholders who attend are not likely to be men of much weight and influence. Partly because of these conditions, many able business men decline to invest in any corporation in which they cannot protect their interests by a controlling voice or at least a seat in the directorate.

In other countries, the tendency of the management to ignore the stockholders has not yet gone so far. Corporations in these countries are not of such enormous size as those in America. The custom of meeting the directors and officers at least once a year and of persistently seeking information as to the internal affairs of the company has not fallen so completely into disuse.

The English Practice

The English statutes provide for the auditing of each company's accounts by an independent accountant elected by the shareholders. The auditor is responsible to the shareholders and not to the directors, and he is legally liable to reimburse the company for any loss which he might have prevented. The courts have said that it is the duty of an auditor not to confine himself to verifying the arithmetical accuracy of the balance sheet, but to inquire into its substantial accuracy. The report of the auditor must be sent to the shareholders. The courts have further said that an auditor does not discharge his duty by simply putting the shareholders in the way of obtaining information; he must state his conclusions in unmistakable terms.

The absence of any corresponding machinery in the United States places the shareholder in a peculiarly helpless situation, especially when he suspects impropriety on the part of his directors. On July 2, 1914, W. Bourke Cockran, an eminent New York attorney, representing a stockholder of the International Steam Pump Company, appeared before the Supreme Court of the State of New York in an effort to compel the directors of the company to furnish more complete data than his client had previously been able to secure. "Doesn't the existing law on corporations give you sufficient power to go in and inspect the books?" asked Justice Weeks. "Why, your Honor," replied Mr. Cockran, "they would only laugh at any one who really tried to get at the books. It would take until doomsday."

Under recent decisions the New York courts have made it possible for shareholders to inspect the stock ledger and transfer books of their corporations for the purpose of procuring a list of the stockholders. This right has, beyond question, been abused by various individuals who have made copies of lists of shareholders for the mere purpose of using

them as mailing lists for advertising purposes. These lists of shareholders of important corporations have even been advertised for sale. Nevertheless, in spite of this abuse, the right must be maintained and enforced; otherwise a shareholder of a large corporation, even though he might have important information that would affect the votes of his fellow shareholders, would have no economical and effective way of communicating with them.

On the basis of what has just been said as to the rights of shareholders, it is evident that large discretionary powers must be left to the directors. No matter what improvements might be made in the relations of the shareholders to their corporation, they could not themselves undertake the direct management of its affairs. In very small or close corporations it is possible that the individual shareholder may have some personal influence which could be made of value to the corporation, but in large corporations the individual can accomplish little except through his vote or through membership on the board of directors. The Pennsylvania Railroad Company has over 93,000 shareholders, of whom 45,000, or nearly one-half, are women; the women shareholders own over 28% of the outstanding stock. The American Telephone and Telegraph Company has 62,000 shareholders and the United States Steel Corporation has 110,000.

Rights and Duties of Directors

The board of directors has the final legislative and judicial authority within a corporation. The board elects officers, determines policies, authorizes contracts, passes on methods of financing, declares or withholds dividends, and in general manages all the affairs of the corporation. This describes their legal status and responsibilities.

In practice, however, boards of directors are likely to become mere appendages or echoes of some one or two in-

dividuals who actually direct the corporation. The real, final authority is frequently lodged in the president, if he is an active man and performs all the duties of his office, and the board of directors simply ratifies his decisions. This is frequently the case even though the directorates may be made up of able and forceful men. Under the American system they have no direct interest, except as shareholders, in the profits of the corporation, and cannot afford to devote a great deal of time and thought to its activities. They have confidence, presumably, in the president or in the chief officer or officers, whoever they may be, and they prefer for their own convenience and comfort to leave the whole corporation in the care of its actual head. The thing that frequently happens, therefore, is that the shareholders elect directors; the directors elect a president or other chief officer; and this man designates the other officers, fixes the policy of the concern, and carries on all its affairs subject only to the formal ratification of his board. So long as the president and other officials are well chosen, the system works well. Its weakness lies in the fact that the directors themselves are poorly informed and are left in a helpless or ignorant condition as compared with the officers; hence they are quite unable to protect themselves or the corporation against practices on the part of the officers that are perhaps detrimental. In place of a representative democracy, which is the ideal form of government for a corporation, they substitute a small tyranny.

This common state of affairs is due, in the United States, partly to the custom of choosing directors of important corporations from a very small circle of well-known business men. The result is that one man may serve on 10, 20, 50, or even 75 different boards. Even though some of these boards may be those of subsidiary corporations which transact nothing but the most formal business, nevertheless the men who are members of so many boards cannot be thoroughly in-

formed as to any of them. Within the last two or three years, there has been a significant tendency to reduce the number of directorates of which one man is a member, but the number is still too large. William H. Newman, for instance, Chairman of the Board of the New York Central Railroad Company, who was at one time a director in 112 separate corporations, is now a director in 73 companies. H. L. Doherty, who is largely interested in public utility properties, is a director in 66 corporations. W. K. Vanderbilt, Jr., is a director in 65 corporations. E. T. Stotesbury is a director in 58 corporations. In England there was at one time a custom of filling directorates with gentlemen of title, most of whom were incredibly ignorant of all business transactions. More recently, according to Hartley Withers, it is becoming more the fashion to put in men who are supposed to know something about the business, "but the real requirement, that of genuine business capacity, is still to a large extent left out and probably must be as long as directors' fees are on their present absurdly small scale."

Corporate Officers and Directors

At the other extreme is the small corporation which makes all its officers directors and allows its directors to make themselves officers. It is, of course, quite proper and customary that some of the leading officials should be included in the directorate, but a directorate that is made up wholly of officers is obviously a body in which there is great danger of "log rolling." An officer who is also a director cannot easily afford to oppose fellow officers and directors who have complete power over him. If there are no outside directors who are not involved in the internal affairs of the corporation to whom he may appeal, an honest, zealous officer is peculiarly in a position of disadvantage. The custom of having all or nearly all of the directors chosen from the officers of the corporation

may work well for temporary periods just as any other unsound arrangement may work for a time. It is, however, fundamentally incorrect and has many times proved a fruitful source of friction and inefficiency.

The "Clayton Bill"

The so-called "Clayton Bill" of October 15, 1914, now makes unlawful in the United States the practice of serving on the directorates of two or more banks, either of which has deposits, surplus, and undivided profits aggregating more than \$5,000,000. The Act further provides that no citizen shall be a director in two or more competitive corporations engaged in whole or in part in commerce, any one of which has capital, surplus, and undivided profits aggregating more than \$1,000,000. The purpose of this measure was to interpose obstacles in the way of improper restraint of trade. Its effectiveness in accomplishing this purpose is open to question. As a method of discouraging business men from attempting to serve on too many directorates and of opening up more opportunities to other men of perhaps equal ability but of narrower reputation, however, it will be beneficial so far as it goes.

"Ornamental Directors"

The report of the Interstate Commerce Commission in 1914 on the financial history and status of the New York, New Haven and Hartford Railroad, strongly condemns inactivity and ignorance on the part of the directors. "There are too many ornamental directors," to quote the plain language of the Commission, "who have such childlike faith in the man at the head, that they are ready to endorse or approve anything he may do. . . . The minutes of the New Haven's meetings reveal that the Board confined itself almost wholly to ratifying and authorizing action; there was little

real information or discussion. None of the directors would have been so careless in the handling of his own money as the evidence demonstrated they were in dealing with the money of other people."

On the other hand, there is sometimes a mistaken idea that the board of directors ought to manage all the details of a business. Its real function is selecting the right officials, outlining policies, and passing well-informed judgment from time to time as to the efficiency and honesty of the management. One of the most successful publishers in the United States, Colonel Henry Watterson of Louisville, recently gave his opinion on the witness stand of directorates which run too much to details. Referring to the management of the New York *World* after the death of the organizer and former proprietor, Joseph Pulitzer, Colonel Watterson said: "I understand that the paper is edited by a Board of Directors. You might as well try to run a locomotive by a Board of Directors. The moment the wisdom of one man or two men is superseded by the folly of one man or two men, the efforts of a lifetime may then and there be wrecked. It has been done repeatedly."

Compensation of Directors

It has been suggested that one reason for the inefficiency and the light ethical standards of the directorates of some important corporations, is to be found not only in wrong practice in selecting these men, but also in wrong practice in compensating them. In many foreign countries, notably in continental Europe, it is the custom to distribute among the directors at the end of each year, a fixed percentage of the net profits; thus each director, even though he may not be a heavy shareholder, has a direct and personal interest in building up the profits. He is less likely to wink at incompetence or to avoid criticism that would be for the good of the cor-

poration, if he realizes that he must himself pay a portion of the penalty in the form of reduced compensation. Paul Warburg, formerly of the firm of Kuhn, Loeb and Company, has expressed his belief that in this country we should follow the European plan of paying directors in proportion to the dividends they can earn. One important gain in this plan is that it becomes easier to secure as directors men who may themselves have only a small shareholding interest in the corporation; the range of choice is widened. As matters stand now, a man wishes to be a director of an important corporation for either one of two reasons: because he has a large share-interest that he feels he should protect, or because it adds to his prestige. This second motive has a strong influence in making up the directorates of banking institutions. "Membership on the boards of good banks," someone has said, "is largely a social function." This is not the way to get efficient, hard-working directors. Under our system it is common practice to pay nominal fees for attendance at board meetings, but they seldom amount to more than \$20 a meeting, and, therefore, these fees are not a factor of any real weight.

This question of compensation as well as some other questions that are touched upon in this section, will come up for fuller discussion when we consider the subject of exploitation of corporations. (See Chapters XXIII, XXIV.)

Legal Status of Directors

As to the legal status and responsibilities of a director, it seems to be well settled that a director is a quasi-trustee on behalf of the body of shareholders. He is certainly not entitled, either legally or morally, to use his position primarily for his personal profit at the expense of the other shareholders. While there is no question that this is frequently done, and as we shall see later on is often defended, it is permitted in

many companies to continue only because the shareholders cannot offer legal proof of their suspicions.

A director ordinarily is not liable to the stockholders for acts of his co-directors unless he participates in the action or acquiesces by not making a vigorous protest. Just what is meant by "vigorous protest" is difficult to say. Where the wrong is serious, the directors ought to apply to the courts. In New York State there is a provision to the effect that directors must file their protest, in writing, or cause it to be entered in writing on the minutes.

Contracts with Directors

A question that frequently arises, relates to contracts between a corporation and a director, or between a corporation and another enterprise in which a director is interested. There are several views in the various jurisdictions as to the validity of such contracts. In New York the law is somewhat unsettled, but several decisions have been made to the effect that they are voidable but not void, and that they are therefore binding on the corporation at its own option. The United States Supreme Court has held that such contracts may be voided if lack of good faith is proven, but that they are presumptively valid. The United States Steel Corporation has an interesting proviso in its by-laws covering this point, which reads as follows:

Inasmuch as the directors of this Company are men of large and diversified business interests, and are likely to be connected with other corporations with which from time to time this Company must have business dealings, no contract or other transaction between this Company and any other corporation shall be affected by the fact that directors of this Company are interested in or are directors or officers of such other corporation, if at the meeting of the Board or at the Committee of this Com-

pany making, authorizing or confirming such contract or transaction, there shall be present a quorum of directors not so interested; and any director individually may be a party to or may be interested in any contract or transaction of this Company provided that such contract or transaction shall be approved or be ratified by the affirmative vote of at least 10 directors not so interested.

CHAPTER IV

THE CORPORATE FORM—ADVANTAGES AND DISADVANTAGES

Corporations in Modern Business

The great commercial agencies of the United States list about 1,700,000 individuals, firms, and corporations as being in business. About 350,000 corporations in the United States made returns under the Corporation Tax Law of the United States for the calendar year 1912. This would seem to indicate that about one-fifth of all business enterprises are organized in the corporate form. However, these figures do not in themselves give anything like an adequate idea of the relative importance of the corporate form. The 80% of business enterprises owned by individuals or by partnerships include, with comparatively few exceptions, only small concerns. The 350,000 corporations include nearly all the important enterprises of the country. It is interesting to note the distribution of these 350,000 corporations on the basis of their capitalization, which is as follows:

296,670 corporations with capital of less than \$1,000,000						
4,688	"	"	"	"	\$1,000,000 to	\$2,000,000
1,399	"	"	"	"	2,000,000 "	3,000,000
677	"	"	"	"	3,000,000 "	4,000,000
292	"	"	"	"	4,000,000 "	5,000,000
861	"	"	"	"	5,000,000 "	10,000,000
652	"	"	"	"	10,000,000 "	50,000,000
62	"	"	"	"	50,000,000 "	100,000,000
65	"	"	"	"	100,000,000 and over	

In other countries also, large enterprises are almost always organized under the form corresponding to the corporation. In

the three years 1911-1913, nearly 1,000 joint-stock companies were authorized to operate in Russia; the average capital was about \$750,000, showing that they were nearly all large enterprises. In Japan, out of 1,445 commercial banks, only 54 are owned by individuals and the rest by joint-stock companies.

The Number of Small Corporations

Yet, the corporation is by no means confined in its usefulness to concerns doing an enormous business. On the contrary, it is becoming every year more and more frequent to organize even small enterprises in this form. The "one-man corporation" or "the close corporation" is no longer an isolated phenomenon. Thousands of men who prefer to have themselves and their estates relieved from possible liabilities due to misfortunes of business, or who wish to organize in such a way that it will be easy to sell interests or gradually to transfer the control, have decided to adopt the corporate form. The expense of so doing is slight, and they feel that it is well worth while.

It is becoming more and more common also to incorporate the estates of deceased persons and to distribute shares in the corporation among the heirs of the estate so that a proper division of interest may be secured without a physical division or forced sale of the property. Small corporations for temporary purposes, also, are not uncommon. An individual may get up a corporation to publish a book or to carry through a piece of speculating in real estate.

Indeed, the question is often raised whether this tendency is not being overdone; whether many enterprises that would be better off as temporary syndicates or as special partnerships, are not unthinkingly being made over into corporations. As regards many individual cases, the question is no doubt well justified. On the whole, however, there can be little question but that the corporation has proved itself useful, sound, and

economical, not only for nation-wide and world-wide concerns, but for small and local enterprises as well.

The Army of Stockholders

Another point to consider here is the great number of persons interested in corporations as holders of their stocks and bonds. Recently, 195 companies have reported to the *Wall Street Journal* a total of 779,054 stockholders. This takes no account of bondholders. There is, of course, a vast amount of duplication due to the fact that the lists of these 195 companies are not checked against each other, and one man may be a stockholder in a great many different companies. Even making this deduction, it is clear that American corporations have a great number of stockholders. On a smaller scale, the same thing is true in other countries. It constitutes one sound reason for saying that the corporate form of organizing enterprises is becoming one of the far-reaching factors in modern business life.

Types of Business Corporations

Some reference has been made in Chapter III to the ancient religious and charitable corporations from which the idea of a distinct existence for the corporation, apart from the people who organize and manage it, was derived and applied to business corporations. In modern times this class of religious and charitable corporations has been broadened to include all corporations not organized for profit. They are often spoken of as "non-stock" corporations. This term now includes municipal and other chartered governments and societies, as well as religious and charitable corporations. For the most part these non-stock corporations are not concerned directly with business enterprises, and we need give them no further consideration. There are a few exceptional cases of corporations chartered in this form for business purposes,

such as stock and produce exchanges and business associations of various types.

Close and Open Corporations

In the ordinary business corporation, an important practical distinction is to be made between "close" and "open" corporations (in England more frequently called "private" and "public" corporations). A "close" corporation is one the stock of which is held by only a few persons who make very few purchases or sales so that there is no public market for this stock. An "open" corporation is one the stock of which is constantly being bought and sold so that the ownership varies from time to time. There is obviously no clear-cut line of distinction. Many corporations enjoy only a small and local market for their shares, but nevertheless are in part "open" in the sense that there would be no difficulty for an outsider to purchase a few shares at any time he chose. On the other hand, there are many large and highly successful corporations the stock of which is in the hands of a few individuals who do not care to dispose of it. As will be pointed out more fully a little later, the tendency in the United States has been to concentrate the attention of the investing and speculating public largely on the shares of a few great corporations, with the result that other corporations have not had as full and free a market for their shares as may be found for corporations of the same size and class in other countries.

A "close" corporation is usually a direct successor to a partnership; or, if not, is a small concern. As a business enterprise expands and more and more people become interested, first the partnership is changed to a corporation, and later the shares of the corporation begin to be passed from hand to hand. Almost insensibly the concern gradually begins to emerge from the ranks of "close" corporations and, if it keeps on expanding, eventually finds its shares widely dis-

tributed and passed from hand to hand. This is the common, but not the universal, process. Among the large companies in the United States the shares of which are reported to be closely held, are the Winchester Repeating Arms Company, the Mills and Gibb Company, the Jones and Laughlin Steel Company, and the Cerro de Pasco Investment Company.

Holding Companies

A striking development of recent years has been the growing use and importance of companies which hold the stock of other corporations. There was originally no thought that corporations might be organized for any other purpose than to conduct directly the business operations specified in their articles of incorporation. It was in time discovered, however, that among the possible powers of a corporation, it might hold securities of other corporations just as an individual might do. At the beginning, the only use made of this power was to purchase interests that could be regarded as useful to the corporation or as subserving the main purpose for which it was created. This remains today the most common and important purpose for which corporations acquire the shares of other corporations.

But the holding company device has proved extremely useful also for another purpose on which public attention has been largely centered. This purpose is to achieve a combination of competing concerns which will restrain competition and be within the requirements of the law. This subject has been so fully discussed in various books and articles that it needs only a brief reference. Before the adoption of the "holding" company device, combinations of competing concerns had been effected in several different ways. The first attempt to achieve such combinations in the United States was made by competing railroads which worked out various "gentlemen's agreements" for the regulation of rates and competitive methods. These

agreements never stood the strain of every-day use for any long period. They always broke down because they were not hard and fast contracts; they were differently interpreted by the various individuals who entered into them and had no legal sanction.

The Illegal Combination

Another form of combination that has proven unsuccessful in this country—though it has worked to some extent abroad—is the “pool” or selling agency, which is an agreement to restrict production and sales, and which frequently accomplishes this purpose by having all the sales of the competing companies handled by one selling organization. This arrangement was found to be illegal in this country and was given up more than a generation ago.

Its successor was the “trust,” using that word in its legal, not its popular, sense. Under the “trust” form of combination, controlling shares in competing corporations were turned over to a group of trustees who issued in exchange their trustees’ certificates. The trustees were able in this way to direct all the corporations and to restrain their competition with each other. In the late 80’s this arrangement also was found to be illegal and consequently the trusts were dissolved.

Shortly afterward began the use of the “holding” company to accomplish this same purpose. One corporation was formed which purchased the controlling shares of competing corporations and was thus able to direct them in the same way that the trusts had previously done. After many years of agitation and litigation, this method also has in recent years been found to be illegal. Some of the large holding companies have been dissolved by order of the courts and others have voluntarily relinquished their holdings of stocks of competing companies.

Legality of Holding Companies

Out of the discussion and the various legal measures that have been taken, there has arisen a popular feeling that all holding companies are questionable, and it has even been seriously proposed that a corporation should be forbidden to hold stock in any other corporation. Yet, as a matter of fact, no real legal objection to a holding company itself has ever been raised. The only question has been whether the holding company has been used for purpose of restraining trade and competition, and it is that use which is forbidden. For any purpose that is not illegal, a holding company may be used as effectively and with as little legal objection as ever.

Combination of Non-competitive Companies

There are two other purposes for which one corporation may hold the stock of other corporations: one purpose is to bring about a grouping or combination of concerns that are non-competitive; the other purpose is to control subsidiary corporations in such a way as to advance the main interests of the holding company, but not with a view to preventing or restraining competition. We find the best illustration of the first of these two purposes in the public utility field. There are about 140 large holding companies which own controlling interests in a number of electric light and power, gas, and traction corporations. Of approximately \$2,112,000,000 of securities issued by electric light and power companies, about 82.5% are owned by these 140 holding companies; of about \$1,320,000,000 of securities of artificial gas companies, about 66% are owned by the holding companies; of \$4,043,000,000 of securities of traction companies, about 81.4% are owned by the holding companies. So far as the available records show, only one holding company in this class has ever been placed in receivership, and that was on account of financing large irrigation schemes.

The chief advantages of applying the holding company plan to public utilities are:

1. Most of the local companies are in small cities and do not have the resources which would enable them to employ high-priced talent. The holding companies, through their superior resources and organization, are able to increase the efficiency of the local companies.
2. While the securities of the local public utilities can be sold only in or near the place of their operations, the securities of great holding companies enjoy a national and even international market and consequently can be sold more widely and on a much better basis.

There appears to be no reason to condemn the holding company in this field. On the contrary, it has been continually an aid to economy and efficiency. The London Underground Electric Railways is purely a holding company. There are, however, comparatively few examples outside the United States of this device.

The Use of Subsidiary Corporations

The control of subsidiaries may be accomplished through the creation of a separate corporation to handle a distinct phase of the company's business, or through the purchase of interests in companies previously existing, the main corporation being in this case the holding company. The use of subsidiary corporations is becoming more and more extensive. A certain manufacturing corporation, for instance, has one operating company, one selling company, one purchasing company, one company owning a short railroad, one real estate company to buy land and erect buildings, and another company to operate these buildings. The United Cigar Stores Company also has

a distinct corporation for the handling of its real estate operations.

Advantages of Subsidiary Corporations

The advantage of forming a distinct corporation rather than simply establishing another department of the business, is not always clear to the outsider, but may frequently be due to personal relations. A first-class real estate man, for example, may not desire to come to a corporation as a paid employee, but would be willing to assume the management of a distinct corporation under conditions that would enable him to secure adequate profit. Again, it is frequently desired to give the manager of a plant or of a branch office an opportunity to acquire a personal stock interest in the operations directly under his control, and this can be most easily done through the formation of a separate corporation. Recently, a case was brought to the writer's attention of a furniture company which has gradually extended its business until it now handles various lines not strictly connected with the furniture business, including papers for wrapping and packing furniture. This company found that difficulty was being experienced by their sales force in calling upon people interested in the paper business because of the impression that the salesman had only furniture for sale. The difficulty was easily overcome by forming a separate company to handle the sale of paper, with a separate name, stationery, and sales manager, but otherwise conducted as a part of the parent concern.

It may be thought strange that a corporation holding a charter and grant of powers from the state, could be organized so lightly and for so minor a purpose, yet the illustration is not unrepresentative. It has become so easy and common a thing to organize a corporation for some specific purpose, that it is frequently done with very little thought and often when little or nothing is gained. Possibly this tendency is going a

little too far, and might properly be curbed by closer supervision on the part of the state and by somewhat higher organization and franchise taxes. On the other hand, we should not overlook the usefulness of the arrangement in many instances, and should not be misled by a cry against holding companies into condemning or preventing practices that on the whole make for business efficiency.

Advantages of Corporate Form

The underlying advantages of the corporate form for most business concerns, have already been indicated in pointing out the disadvantages of the individual proprietorship and partnership. They may be listed as follows:

1. The corporate form makes it possible to distribute ownership among any number of persons and thereby to raise very large amounts of capital.
2. The relationship between the owner of a corporate security and the business itself being purely impersonal, the securities which represent ownership may be freely transferred.

These two points make a corporation attractive to investors.

3. The liability of owners of corporate securities is limited to their investment—or in certain exceptional cases to a larger amount bearing a fixed proportion to their investment.
4. The fact that the ownership and management are separated makes it possible to procure a high grade of specialized talent for managerial positions, whereas in a partnership form the partners themselves usually fill these positions; in many lines of business, for instance, railroads and public utilities, this is a striking and important advantage.

5. The life of the corporation is not dependent upon the lives and activities of individuals; the duration of the business, therefore, is not so immediately affected by the misfortunes of individuals.

One or two examples will indicate how these advantages may be utilized in different fields of operation. Some two years ago a real estate operator was able to secure control of a tract of land of about 600 acres, situated on the outskirts of a small city in the Middle West, which proved to have on it some valuable beds of gravel and clay. A portion of the property also was suitable for cutting up into small residence lots. The operator paid about \$300,000 for the property. He estimated that with proper management it should have a value of over \$600,000, yet he was himself unable to handle it and had found great difficulty in securing a buyer. Under these conditions he was advised to form a corporation, issue bonds and capital stock which could be sold not only in the near-by city, but at various other points, and thus secure for the corporation the funds with which to go ahead with the development of the property. The plan was finally adopted after considerable delay, and at this writing is in process of being successfully worked out. In no other way than through the organization of a corporation would it have been practicable to finance this undertaking.

Advantage of Partnership Incorporation

A somewhat similar instance arose in connection with the dissolution of a partnership due to disagreement and personal friction between the two partners. One partner, who owned a one-third interest in the business, had in addition about \$50,000 and desired to purchase control. The other partner was willing to sell. However, the total value of the business approximated \$300,000, so that it seemed to the minority partner impossible to buy the two-thirds interest he wished

with but \$50,000. The solution of the difficulty was found in organizing a corporation which issued notes, preferred stock, and common stock. The majority partner took all of the notes and preferred stock and a portion of the common stock for his share; the minority partner took common stock alone and received enough to give him control of the new corporation. The corporate form, in this case, proved sufficiently elastic to enable the two partners to adjust satisfactorily a situation which otherwise would have led to costly quarrels and litigation.

Under personal ownership, either by individuals or by partnerships, it is difficult if not impossible to make an adjustment of claims upon the property which will correspond exactly to the various shades of desire for management, income, and risk. The corporate form is peculiarly well fitted for dividing and recombining and for issuing various forms of securities in such a way as to bring about this desired correspondence.

Advantage of Continuity of Ownership

Again, the great advantage of continuity of ownership of a business, even though one or more of the persons jointly interested may die or withdraw, is often of paramount importance. William L. Douglas, it is stated, owns all of the common stock of the W. L. Douglas Shoe Company of Brockton, Mass. An arrangement has been made, however, to appoint three trustees who, in the event of Mr. Douglas' death, would carry on the business along lines that he has marked out.

Disadvantages of the Corporate Form

There are certain minor disadvantages of the corporate form which may in some cases be of sufficient importance to prevent the adoption of this form. The first and most im-

portant is simply the obverse of the advantage of limited liability for the shareholders. Sometimes this advantage involves placing a corresponding *limitation on the credit of a corporation*. Let us suppose the case of a wealthy man who desires to back a small trading concern. If he becomes a partner in the concern, thus placing behind it his personal resources, it may be presumed that the concern will have all the credit that it can properly use. On the other hand, if he merely takes shares in a corporation, he has no further legal obligation in connection with the business, and his action in some circumstances may even be regarded as indicating a lack of confidence. Undoubtedly the corporate form does lend itself to certain kinds of swindling operations. It has been too common an occurrence for unscrupulous retailers to form a corporation, purchase a stock of goods on credit, dispose of the goods, transfer the money to themselves, and let the corporation go into bankruptcy. Such happenings tend to arouse suspicion, and in some lines of business may lead to undue restriction of the credit of small corporations.

Yet this result is not unavoidable. It is quite possible for any shareholder or any group of shareholders who desire to do so, to put their personal indorsement on the notes of a corporation or to give personal guarantee covering payment of the corporation's accounts. In so doing the shareholders would place themselves in no worse position than if they were to become partners in the business.

The second disadvantage is governmental control. This has already been alluded to in speaking of the reasons why many banking and brokerage houses are not incorporated. Financial corporations are under specially close supervision and limitations on their business.

Most states require all corporations to submit periodical and detailed reports to boards or officials; this causes considerable trouble and expense, but, as necessitating system in

keeping corporate records, it is sometimes worth all the labor it entails.

The third minor disadvantage is the expense of organizing a corporation. This expense is always small in proportion to the capitalization. The organization tax, plus the filing and incidental fees, of a \$100,000 corporation in New Jersey is \$35; in New York \$65; in Delaware, \$25; in Maine, \$67; and in South Dakota, \$18. The yearly franchise taxes for a corporation of this size are in New Jersey \$100; in New York, \$150; in Delaware, \$10; in Maine, \$10; in South Dakota, nothing. Other expenses, such as lawyers' fees for drawing up the corporation charter, and the like, should not be large. The act of incorporation is nothing more than routine legal business.

In Canada, a Dominion or Federal charter is issued upon payment of a fee of \$250 for a capitalization of \$200,000, plus 50 cents for every \$1,000 additional. There are also license fees to pay to the government of the province in which the company does business, which may amount to \$200 to \$350 for a corporation capitalized at \$200,000. In all other modern countries, the fees and expenses are small unless an attempt is made to procure a special charter instead of operating under the general Incorporation or Companies' Act; in that case the cost may become very high indeed.

A fourth disadvantage that may be mentioned is the fact that the charter and by-laws of a corporation give a certain fixedness to its organization and its powers which may at times prove more or less embarrassing. If these documents, however, are wisely drawn, it is unlikely that there can be any trouble of this nature; if there should be any such trouble, it is nearly always a very easy and simple matter to make such amendments as are called for.

The incorporation under state laws also makes it necessary to procure certificates allowing the corporation to operate in

other states than that in which it is incorporated, when this is desired, and this usually involves some expense.

Corporations doing business in more than one state are also liable to be taxed by several states on the same property, while at the same time their shareholders may also be paying taxes on their respective interests in the stock, making a double or treble tax on the same property.

All these disadvantages, it is clear, are for most corporations of slight importance. They have evidently not proved a serious obstacle to the adoption of the corporate form, for this tendency has gone on year by year, increasing in strength so that now it is uncommon for enterprises of any size, with the few exceptions noted above, to be organized in any other form.

Efficiency of Corporate Organization

Adam Smith, the first and perhaps the greatest of economists, was extremely skeptical as to the usefulness of the large "joint-stock" companies which in his day were just beginning to play a prominent part in business life. "Without a monopoly," he says, "a 'joint-stock' company, it would appear from experience, cannot long carry on any branch of foreign trade, for it is a species of warfare in which the operations are continually changing, and which can scarcely ever be conducted successfully without such an unremitting exertion of vigilance and attention as cannot long be expected from the directors of a joint-stock company." Elsewhere he asserts that "negligence and profusion must always prevail more or less in the affairs of a 'joint-stock' company."

In view of the rapid spread of the joint-stock or corporate form of organization and the immense number now in existence, it may seem at first glance that wise old Adam Smith for once was entirely wrong. Yet, if he were to step into twentieth century life and read all the details of the life in-

surance scandal, the New Haven Railroad scandal, the Rock Island Railroad scandal, and the various other unsavory messes that are from time to time brought to light, he would perhaps not be easily convinced.

As a matter of fact, it is probably true that the various advantages cited in preceding paragraphs are responsible for the wide-spread adoption of the corporation, rather than any claim it can reasonably offer to superior efficiency.

There are some features of corporate organization which are no doubt an improvement in respect to efficiency, over any other forms of organization. The people who supply the money are not necessarily the ones who personally manage the enterprise; and this leaves or should leave an opportunity to engage men of special talent as managers. The custom at one time was to select one of the largest stockholders as the nominal president of an important bank, railroad or manufacturing corporation, but this has now been largely abandoned in favor of making the president the responsible manager. Often he holds only a few shares of stock. The most important or influential stockholder, instead of becoming president, is more frequently made chairman of the board—a position which usually pays no salary. Furthermore, it is at least theoretically true that the creation of a board of directors representing the owners of the business who can oversee and check or stimulate the officers, is a striking gain. On the other hand, these advantages have been in large part nullified by the selection of incompetent or overoccupied directors. As Adam Smith foresaw, these men are not so zealous in protecting the shareholders as they are in advancing themselves. Sometimes responsibility is so divided that it rests too lightly on the shoulders of each individual director. Hartley Withers makes the interesting comment that "the real business of most boards is done by a small minority who save the rest from the consequences of their inexperience. In actual practice the

notion that the board is chosen by the shareholders or is really representative of the shareholders, is generally a delusion. The board either forms itself or is formed by the promotor and fills its own vacancies, subject only to the purely formal confirmation of the shareholders. The officers are chosen by the board or by one another, and joint-stock companies are thus governed in practical fact by a self-elected oligarchy." This is true not only in London, which Mr. Withers has in mind, but in New York, Montreal, Paris, Berlin, and every other part of the world. How do these self-chosen oligarchies work, and what do they accomplish?

Insolvency of the Northern Pacific

During most of the period 1882-1892, Henry Villard was not only a director of the Northern Pacific Railroad Company, but was president of the company, and was generally regarded as its active and responsible head. Writing in 1905, however, in his "Memoirs" and no doubt wishing to excuse himself in part for the insolvency of the company under his management, Mr. Villard said:

In 1891 Mr. Villard made his last official tour of inspection of the main line and principal branches of the Northern Pacific The most alarming impression of all made upon him was the revelation of the weight of the load that had been put upon the company by the purchase and construction of the longer branch lines in Montana and Washington, which he then discovered for the first time They represented a total investment in cash and bonds of not far from \$30,000,000, which together hardly earned operating expenses. The acquisition and building of these disappointing lines had in a few years absorbed the large amount of consolidated bonds set aside for construction purposes, which had been assumed to be sufficient for all needs in that direction for a long time.*

*Quoted in Stuart Daggett's "Railroad Reorganization," pp. 286-287.

It is clear that Mr. Villard, whatever may have been his abilities and good intentions, was not devoting sufficient attention to the business of this corporation to qualify himself to direct it.

Management of the Colorado Fuel and Iron Company

Some interesting testimony along somewhat the same line was given in April, 1914, by John D. Rockefeller, Jr., who was called before a subcommittee of Congress and questioned as to his control over the Colorado Fuel and Iron Company. Mr. Rockefeller testified that his father held 40% of the common and 40% of the preferred shares in this company. He stated that he was a member of the board of directors, but did not attend meetings, and explained that he had every confidence in the officers of the company and kept in touch with them by correspondence. The chairman of the committee intimated that Mr. Rockefeller should have attended an important meeting in October. "If you mean that I should have gone to Denver to attend a meeting of the board of directors," was the reply, "I will say that it is not by attending the board meetings that we keep in touch with the officers. If the time comes when we cannot rely on the officers then we will get somebody else, for it is impossible for us to attend to all of these things ourselves, and we have got to get the ablest men obtainable to act for us."

Avoidance of Centralization

Another criticism frequently levelled against the efficiency of large corporate organizations, is based upon the alleged inability of the board of directors sitting at the head office to grasp and appreciate conditions at the branches. Sometimes, it is asserted, with regard to the holding companies operating in the public service field, that the supervision extended to subsidiaries is inadequate, and that headquarters

lacks personal touch with the local situation of each subsidiary and with the temper of the public that is being served. In some cases this criticism has been frankly accepted as in part valid, and the remedy has been found by securing as directors for local subsidiaries the strongest and best men in the local communities.

Duties of Directors

On the whole, there seems to be reason for believing that corporate organization is tending to increase in efficiency. Shareholders and the investing public are becoming more and more acquainted with the evils of careless and irresponsible direction of their properties. They are gradually becoming acquainted, also, with the more common methods of exploitation and are insisting upon remedies. The only real and permanent remedy for corporate inefficiency lies in the development of higher standards of business morality. Directors should be sincerely convinced—as perhaps a majority of directors are—that they are in a position of trusteeship which they have no right to accept unless they intend to fulfil all its duties vigorously and conscientiously, and that next to actual dishonesty, the most serious charge that can be made against a director is negligence; in fact carelessness in handling other people's money is itself a form of dishonesty. When this truth is so widely recognized and so thoroughly driven home that it cannot be lightly overlooked, the corporate organization will begin to achieve its proper ratio of efficiency.

Part II—Capital

CHAPTER V

OWNED CAPITAL

Owned and Borrowed Capital

The capital funds used in business enterprises fall into two classes, "owned funds" and "borrowed funds." In an individual proprietorship or in a partnership the distinction is clear and easily made. The total value of the assets of such a business is represented on the liability side of the balance sheet, first by obligations, or "borrowed funds," and secondly by proprietorship, including whatever surplus has accumulated.

In a corporation the distinction between "owned" and "borrowed" capital is not always so clear, nor is it so vital. The corporation itself owns all of its assets and owes not only its obligations, but also its capital stock and surplus. The creditors and the shareholders of the corporation hold varying amounts and degrees of claims against the corporation which almost imperceptibly shade into each other. The distinction between debenture bonds and certain types of preferred stock is slight. Indeed, it would be difficult to name any dividing line which clearly separates the shareholders from the obligation holders, or creditors, of a corporation.

Nevertheless, we may in general follow the customary line of distinction and say that most bonds, notes, accounts payable, and other obligations of a corporation, may be regarded as representative of borrowed capital, and most shares of capital stock may be regarded as representative of owned capital.

Some companies have practically nothing but owned capital; that is to say, their borrowings are almost nil. Ordinarily, the only corporations in this condition are those which have just started, or those which are small and struggling and have not the credit which would enable them to borrow even on short time. Once in a while, however, we find a large corporation which follows the same policy. For instance, the W. L. Douglas Shoe Company carries on the liability side of its balance sheet only common stock, preferred stock, and a small amount of current accounts payable.

A small enterprise is usually conducted on the owned capital of the proprietor or the partnership, with possibly recourse to the bank for short-term loans from time to time. Also, the proprietor or one of the partners will sometimes borrow money for the business on his personal note, secured perhaps by mortgage of his real estate, and thus increase his investment and the amount of the partnership's owned capital by the amount so secured.

When there is a single proprietor, he may perhaps, when additional capital is required, secure this by the admission of a partner with capital. A partnership might accomplish the same result by adding another partner. It is possible at times for firms to secure additional capital by admitting special or limited partners, who take no active part in the business but who invest capital and share in the profits. In many states the statutes provide that the special or limited partner shall not be liable to creditors of the firm beyond his investment.

When the statutes do not provide for limited partnerships, the same end may be accomplished by admitting a dormant, silent, or sleeping partner. The dormant partner takes no part in the business, and usually avoids publicity as to his connection with the business. If known to be a partner, he may be held for the partnership obligations, like any other member of the firm.

It is, of course, always possible for a sole proprietorship or partnership to incorporate and issue stock; if it does so, its capital problems are then the same as those of any other corporation. Many small businesses have been incorporated, and most businesses when they increase to a certain point incorporate, on account of the facility given by the corporate forms in securing additional capital.

Stocks and Shares

The title of this section is borrowed from an exceptionally readable book by Hartley Withers, to which reference is made below. At first glance the combination of words in the title seems to the American reader so much nonsense, for in the United States we are accustomed to apply the two words "stocks" and "shares" almost indiscriminately, both meaning the units of a corporation's owned capital. We derive our meaning of the word "stock" in its financial sense from its original meaning of something heaped up like a stack; this is the sense in which it is used in the phrase "stock in trade." Adam Smith uses the word to mean the capital of a firm or company, and this meaning has survived in the United States, but not in Europe. In England, stock is distinguished from shares by the fact that it is divisible into, and transferable in, odd and varying amounts, ranging from tens of thousands down to a penny. At the original subscription anyone may take any odd amount of the stock that he cares for. The Stock Exchange calls the amount that is not divisible by one hundred, a "broken lot." Stock is quoted on the London Stock Exchange at so much per £100. Shares are distinguished from stock by the fact that they are expressed in terms of definite amounts and are indivisible. There are, however, some few English companies that will transfer fractions of shares.*

*Hartley Withers' "Stocks and Shares," pp. 33-38.

In the United States there is no security which corresponds to what the English call stock. The owned capital of any corporation is always represented by an issue of shares, each share being of a uniform amount with the other shares in the same series, and of like standing and rights. In both countries the capital stock of the corporation may be of two or more classes, which in this country are usually called "common" and "preferred." In England the more usual titles are "ordinary" and "preference," and in that country there is a much larger variety of shares than we have here. There are "deferred" shares, "founders' " shares, "deferred ordinary" shares, "preferred ordinary" shares, and so on almost indefinitely. In this country, after we have used the terms "common" and "preferred" we usually fall back on such matter-of-fact titles as "first preferred," "second preferred," "third preferred," and the like.

Transfer of Stock

Shares of stock are ordinarily represented by certificates issued by the corporation, each one of which states on its face how many shares it represents, to whom it is issued, and the legal conditions, if any, under which the shares are issued. These certificates are transferable and negotiable when indorsed in blank by the person to whom they were originally issued. They may pass from hand to hand, be used as collateral for bank loans, and be transferred many times, before being finally sent in to the corporation for transfer—that is, in order that the name of the new owner of the certificate may be entered as a stockholder and a new certificate may be sent to him. This transfer on the books of the corporation is usually attended to before the transfer books are closed in anticipation of a dividend. Inasmuch as dividends are paid to stockholders of record as they are registered in the books of the corporation, it is desirable that the new owner of a cer-

tificate should be careful to see that his name is entered promptly.

The larger corporations entrust the issuing, handling, and checking of their certificates of stock to a registrar and a transfer agent, both of which usually are trust companies. It is the business of the transfer agent to see to it that the record of stockholders is kept up to date, and that old certificates are cancelled and new ones issued as called for. It is the business of the registrar to check the issuance and see to it that no more are put out than have been authorized and issued for property. This practice of having a registrar to check the transfer agent, is an outgrowth of the era of wild speculation on the New York Stock Exchange in the seventies and eighties, when the leaders were Jay Gould, James Fisk, and Daniel Drew. In their operations these men were not trammelled by any legal or moral restraints. If it suited them to set the printing presses going and secretly to put out large new issues of unauthorized securities, they did so, and were able, apparently, to keep within the bounds of the law. To guard against activities such as these and to make their stocks more readily salable, the older and more conservative corporations started the practice of engaging independent registrars.

A Corporation Dealing in Its Own Stock

A question which often arises is whether or not a corporation may acquire or deal in its own stock. Courts in New York, California, Wisconsin, and other jurisdictions have decided in recent years that, in the absence of statute to the contrary, a corporation may deal in its own stock, provided the purchase or sale is made in good faith and without injury to creditors. However, the statutes of many states specifically forbid this practice. It is obviously objectionable when it is so used as to bring about a reduction in outstanding capital stock without due process of law, or when it is used

as a method of paying off certain favored shareholders at the expense both of the other shareholders of the company and of the creditors.

"Common Stock" or "Ordinary Shares"

In the United States we speak of "common stock"; in England they use the term, "ordinary shares." The two expressions are practically identical in meaning; both refer to shares which have no special privileges or rights but which are entitled to whatever capital or income remains after prior claims have been satisfied. One verbal exception to this general statement may be noted. In English usage there are sometimes "deferred" or "deferred ordinary" shares, which are inferior in claims to the so-called ordinary shares. In this case the shares that are called ordinary are really "preferred." Once in a while the same practice is found in the United States. For instance, the Denver Reservoir Irrigation Company has three classes of common stock, which are known respectively as "A," "B," and "C" common. Voting power is vested only in classes "A" and "B," which accordingly are given preference in this respect over the "C" class. Customarily, however, common, or ordinary, shares are all of the same class and represent the final equity in the enterprise after prior claims have been made.

The simplest case of capitalization arises when a corporation has outstanding only one class of stock, and no notes or bonds. The laws of several states specifically provide that in the absence of any special preference for certain classes of stock, all stock shall be of one class and shall be known as common stock. It is well to keep this rule in mind and to realize that any stock which is set aside and given certain privileges or rights is entitled to nothing more than is specifically assigned to it. We shall see that there is no rule, or even established custom, as to the rights and privileges of

so-called preferred stock. The common stock is entitled to every privilege that is not specifically taken away from it.

Preferred Shares

Although preferred shares are entitled only to what is specifically granted to them, some customs have become fairly well established. In the United States nearly all industrial preferred shares bear cumulative dividends at the rates of 6%, 7%, and 8%, a great majority receiving 7%. Just why these percentages should have been chosen is somewhat difficult to say. Probably the best answer is to be found in the statement that high-grade preferred shares have been selling for several years on about a 7% basis; that is to say, if they are 6% shares they sell at about \$86 for each \$100 shares; if they are 7% shares they sell at about par; and if they are 8% shares they sell at about \$114 for each \$100 share. Inasmuch as shares, when they have a market value of or near par, are more convenient and more salable than would otherwise be the case, there is an advantage in making their preferential dividend 7%. There is, however, nothing fixed in this custom. If the general level of prices changes so that good industrial preferred shares begin to sell at par on a 6% basis, we may expect to see the customary rate changed to 6%.

The preferred dividend may be either "cumulative" or "non-cumulative." A cumulative dividend is one which carries over from year to year; that is to say, in case the profits are not sufficient to pay the full preferred rate in any given year, the unpaid dividends will remain as a prior claim to be paid in some succeeding year before dividends are declared on the common shares. Non-cumulative dividends give the preferred shares a prior claim for dividends each year; but in case these profits are not sufficient to meet the claims, or for other reasons dividends are not declared, no obligation rests upon the corporation to make up the deficiency in later years.

At one time most preferred shares were non-cumulative. But as such they have been found unsatisfactory because of the conflict of interest between the common and the preferred shareholders as to the payment of preferred dividends each year. It is obviously to the advantage of the common shareholders to defer dividends on the preferred shares as long as possible, since the cumulating profits inure directly to the benefit of the common stock. It is a simple matter of accounting procedure to use whatever profits accrue to the corporation to increase assets and to pass preferred dividends, until sufficient profits have accumulated to pay equal dividends to both preferred and common stock. There is plenty of opportunity not merely for unfair diversion of funds away from the preferred shareholders, but also for the expression of differences of opinion as to whether dividends are honestly withheld.

Non-cumulative preferred stock, is as stated, undesirable. It is, in fact, a standing invitation to the directors, unless their ethical standards are high, to administer the corporate finances to the advantage of the common stockholder. Profits that might very properly have been applied to the preferred dividends are diverted into improvements or developments. These redound to the ultimate advantage of the company, but meanwhile stand in the way of dividends on the non-cumulative preferred stock until the company has reached a point where common and preferred stock dividends are both possible. The preferred stockholder's dividends for this period are absolutely lost as far as he is concerned. The company has profited at his expense. The directors might properly have paid them if they would, but decided in favor of the common stockholder.

If investors were wise there would be no sale for the non-cumulative stock, for there is no legal way for the holder of such stock to prevent the directors postponing dividends

until the common stockholders can share equally or even receive more than do the holders of preferred stock.

It is to be noted that if the preferential dividend is to be non-cumulative, this fact must be clearly expressed in the charter provisions by which the stock is authorized. Where not so expressed the courts have held the preferential dividends to be cumulative and payable in full out of the first profits before anything is received by the common stock. The cumulative feature of preferred stock is, however, for the sake of security and definiteness usually covered by express provision.

On the other hand, cumulative dividends have an uncomfortable habit of piling up, and may become in the course of a few years so serious a burden as to leave no reasonable hope for dividends on the common shares. Such a situation might interfere with, or prevent entirely, additional financing were it needed. It is not at all uncommon in corporate experience for a company to go through several years of depression and limited income, and then, through good management or by some fortunate circumstance, suddenly enter upon a period of prosperity. Naturally, the common shareholders, having received no dividends through the "lean" years, feel that they are entitled to some recompense. If a large amount of unpaid dividends on cumulative preferred shares stands in the way, it is now customary to try to find some way, under the conditions stated, of "funding" these unpaid dividends, thus satisfying both the common and the preferred shareholders. The "funding" of the unpaid dividends is accomplished by issuing securities of some kind to the preferred shareholders in exchange for their dividend claims.

Shares may be preferred not only as to dividends, but also as to assets; that is, in case of dissolution or insolvency, the full par value of the preferred shares is to be paid before any payment is made on account of the common shares. We shall see, when we come to consider reorganization, that as

a matter of fact going corporations are seldom sold or entirely liquidated and the assets distributed among the various security holders. It is usual to bring about a reorganization in which the claims of each class of securities are so readjusted that they may all be met by the corporation. Hence the prior claim of preferred shares upon assets is not to be taken too literally, but is to be regarded rather as a legal point of advantage in securing the best possible terms in case reorganization should become necessary. From this point of view, the preference as to assets is of considerable importance.

It is well to reiterate that the preferences granted to preferred shares are no more than are distinctly specified, and that these preferences may consist not only of prior claims as to dividends and assets, but of prior claims as to voting. For instance, the preferred shares of the Rock Island Company of New Jersey (the former holding company for the Chicago, Rock Island and Pacific Railway) were entitled to elect a majority of the directors of that company. It is more usual, however, for preferred shares to have no vote, on the theory that the responsibility for conducting the corporation should rest with the non-preferred shares, which take the greater part of the risk.

In every case in which preferred shares are under consideration, it is necessary to go to the charter or by-laws and find out exactly the nature of the preference. In 1901 there was a struggle between the Hill-Morgan party on the one side and the Harriman-Kuhn, Loeb party on the other, for control of the Northern Pacific Railroad Company, in the course of which the Hill-Morgan party secured a majority of the common shares, and the Harriman-Kuhn, Loeb party a majority of the preferred shares together with enough of the common shares to give them a majority of the entire outstanding stock. Inasmuch as both common and preferred shares had voting rights, it seemed clear that the victory remained

with the Harriman-Kuhn, Loeb group. Unfortunately for their calculations, however, the charter of the company gave the common shareholders a right at any time to redeem the preferred shares at par. This right the Hill-Morgan party exercised and, through the control thus given them by a clause which had apparently been overlooked by their opponents, obtained the upper hand.

Origin and Uses of Preferred Shares

Preferred shares came into popularity in the United States chiefly on account of their influence in railroad reorganizations. It was, and is still, customary in severe reorganizations to cut down the fixed obligations of the corporation by compelling some of the junior bondholders to accept preferred shares instead of their bonds. By making this exchange, the former bondholders retain their claims upon the income of the corporation, but the claim is made simply a preference instead of a positive obligation. Except in reorganizations, preferred shares have been very little used in the United States by railroad corporations.

An entirely different use has been found for them, however, in connection with large industrial corporations. It has become customary to represent the tangible assets and the current earning power of corporations by bonds and preferred shares, and to represent the intangible assets and expected income by common shares. Nearly all of the large industrial corporations formed in the last twenty years have followed this policy. One of the striking features of the stock market during the last five years has been the successful floating of a large number of preferred share issues by the smaller industrial corporations. Sometimes these shares are sound, sometimes unsound. In either case it seems to be fairly easy to dispose of them; the buying public has evidently been educated to like and approve industrial preferred shares.

Preferred shares are sometimes used also to distribute voting power in such a way as to give control to a comparatively small group. The Rock Island preferred shares, referred to above, were of this kind.

In the smaller corporate organizations, preferred stocks are often used to make the adjustments necessary in the incorporation of partnerships. If it is desired to give equality of voting right, the partner having an excess of capital is given a similar excess of stock in non-voting preferred stock. Or, common stock may be given to those who have the management, and preferred stock may be given to those who are to retire from the business. By means of the two kinds of stock, almost any desired difference of investment or power of control may be secured.

Protection of Preferred Shares

It has already been noted that in modern corporations the distinction between owned capital and borrowed capital is sometimes shadowy. Preferred shares, for instance, are sometimes protected and subject to redemption in such a way as to bring them almost, if not wholly, into the same class as junior bonds. It is very common practice for a company to reserve the right to redeem preferred shares, usually at a premium varying from 5% to 20% or more. The decision of the matter, however, rests with the corporation. Further than this, many companies make redemption obligatory and even provide for the building up of sinking funds for this purpose, just as in the case of sinking fund bonds. The California Petroleum Corporation, for example, sets aside five cents on each barrel of petroleum sold, to redeem its preferred shares. The May Department Stores, the Studebaker Company, and the Underwood Typewriter Company all have sinking funds for this purpose. The provision in the charter of the Underwood Typewriter Company reads as follows:

There shall be set apart from the net profits of the Company at the rate of not less than \$100,000 per annum, a fund to be known as "Special Surplus Capital Reserve Account," which shall be made and kept going at the rate of \$100,000 per annum for each year before any dividend shall be paid on the common stock, and after the expiration of three years from the date of incorporation of the Company said Special Surplus Capital Reserve Account shall be used annually in the purchase and retirement of said preferred stock at the lowest price at which the same may be obtainable, but in no event exceeding a premium of 25% over and above the par value thereof. Such purchases may be made at the option of the Company either at a public or private sale, and all preferred stock so acquired shall be cancelled.

It is also becoming a more and more prevalent custom to protect preferred stock by specific provisions as to percentages of current liabilities to current assets, of net surplus to capital, of dividends to current surplus, and the like. The Canadian Inter-Lake Line is required by its charter to establish a cumulative reserve fund equal to 50% of the outstanding preferred stock, and to maintain the fund by setting aside out of earnings an amount equal to at least 3% par value on the outstanding preferred stock. In the case of the Moline Plow Company, the net quick assets must always equal at least \$140 per share of first preferred. Montgomery, Ward and Company provide that no additional preferred beyond the present issue can be put out unless, after such issue, the net quick assets shall equal at least 120% of the outstanding preferred. The Griffin Wheel Company has a number of detailed provisions. Additional issues (after the original issue) of its preferred stock cannot be put out up to more than 66 $\frac{2}{3}$ % of the cost of improvements, extensions, or increased working capital. Common dividends may not be increased to more than 7% unless the net tangible assets are at least 50% of the

preferred shares; even then, the common may get only one-half the surplus earnings above the preferred and previous common dividends. When the tangible assets rise to 200%, the net quick assets being 50% of the preferred, the directors of this company may declare such dividends on the common "as may be deemed prudent."

A form of protection given by many companies is the proviso that the preferred shareholders shall automatically obtain control, or partial control, over the directorate of the corporation in case their claims are not met. It is customary to give the preferred the power to veto an increase of bonds or of preferred stock. The Wisconsin Central Railroad Company provides that in case of failure for two successive years to pay 4% dividends on its preferred, the preferred shareholders shall have the right to elect a majority of the directors. In the American Smelters Securities Company, the preferred shareholders are permitted to vote if dividends for one year remain unpaid. The William Carter Company gives both the preferred and the common shares equal voting power, except that if there is default in four successive quarterly dividends on the preferred, or if the net quick assets for one year remain at less than the par value of the preferred shares outstanding, the preferred becomes the sole voting stock. The American Sumatra Tobacco Company provides that if unpaid dividends accumulate above 14%, the preferred shareholders shall have the right to elect a majority of the board. The International Motor Company provides that if the preferred stock fails to receive dividends, it shall obtain the sole voting power. The American Rolling Mill Company gives its 6% preferred stock the right to vote only when three successive dividend periods have been passed.

All of these provisions appear to be equitable, although the mere grant of voting power to preferred shareholders, if the common shares still retain control of a corporation, may

prove to be a concession of only slight importance. If it is expected and seriously intended that the dividends on preferred shares shall be paid regularly year after year, then it would seem only fair that the common shareholders, if they should fail to live up to this expectation, should forfeit control and give the preferred shareholders a chance to see what they can accomplish. It may be objected that an arrangement of this kind would involve the possibility of shifting the control from one set of shareholders to another from year to year, a practice which would be fatal to the interests of both classes. The answer to this objection is to be found in the fact that whatever minor conflicts of interest may exist between the preferred and the common shareholders, both are likely to do all they can to build up the corporation, and this tendency would probably not prove serious. It may be further suggested that preferred shareholders, after all, bear a considerable part of the risk in most corporations, and ought from the beginning to have at least a small share in the management; they could be given complete control in the event of default in the payment of preferred dividends.

In Canada it is unusual to deprive preference shareholders of their customary right to vote upon their shares. The Companies Act of the Dominion states that:

Holders of shares of preference stock shall in all respects possess the rights, and be subject to the liabilities, of shareholders within the meaning of this Act, provided that in respect of dividends and in any other respect declared in by-laws as authorized by this Act, they shall, as against the ordinary shareholder, be entitled to preferences and rights given by such by-laws.

It is plainly implied here that preferred shareholders are entitled, unless there is some clear agreement to the contrary, to vote on an equality with common shareholders.

Dividend Rights of Preferred Shares

Unless otherwise expressly provided, preferred stock participates equally with the common stock in all dividends after both common and preferred have received an equal dividend. That is, if the preferred stock has received its preferential dividend of, say, 6% together with any cumulated arrearages, it participates no further in dividends until 6% has been paid upon the common stock as well, but thereafter both classes of stock stand upon exactly the same basis as to any further dividends declared during that year. If such further participation on the part of the preferred stock is not desired, it must be expressly denied. Ordinarily the charter contains a provision prohibiting such participation, in which case the preferred shares receive their fixed dividends, but no more. Yet there are numerous exceptions to this general rule. For instance, the American Brake Shoe and Foundry Company pays 7% on preferred shares, and follows that with 7% on common shares; the preferred shares are then entitled to all additional earnings. The Chicago, Milwaukee and St. Paul Railroad Company's preferred has a prior claim to 7% and, after the common has received 7%, shares equally with the common in any further distribution. The Chicago and Northwestern Railway's preferred is entitled to 7%, to be followed by 7% on the common, and then the preferred is entitled to an additional 3% before the common draws anything more. At present the preferred stock of this company is receiving 8%, and the common 7%.

Allis-Chalmers Company preferred draws 7%, then the common 7%, then the preferred is entitled to 1% extra but has no further claim. James Stewart and Company has outstanding \$1,500,000 7% cumulative second preferred, which participates equally with the common in further distributions after the common has received 10%. Harrison and Crossfield, Ltd., a large English house dealing in foreign and colonial

produce—tea, rubber and the like—has outstanding a preferred ordinary issue of £300,000 drawing a cumulative dividend of 5%. After an equal amount has been paid on the management shares, the balance of the profits are divided equally until the preferred ordinary have received a further 5%; the remaining surplus is the property of the management shares. The preferred ordinary shares have received their full 10% dividend each year since the formation of the company. Aberthaw and Bristol Channel Portland Cement Company, an English concern, has a preferred issue which is entitled to 10%, and which, after 10% has been paid on the common, receives two-thirds of the remaining profits.

Redemption of Preferred Shares

There are a number of provisions concerning the redemption of preferred shares, that are worth noting. The General Asphalt Company has outstanding \$14,000,000 5% cumulative preferred which is convertible into common at any time on even terms, in addition to which the preferred shareholder will, in this case, receive also \$50 of common that is held in a trust fund. Thus \$100 of preferred stock can be converted into \$150 of common at any time. The American Oriental Company has outstanding \$2,000,000 7% participating preferred which is convertible into common, share for share. As to the rate of redemption, the Fisk Rubber Company has an unusual provision to the effect that in case of forced liquidation the preferred stock is entitled to par and accrued dividends, but in case of voluntary liquidation it is entitled to 120% of par and accrued dividends. A few English companies base the redemption of their shares of preferred on the market value. Thus Apollinaris and Johannis, Ltd., provide that in the event of voluntary liquidation all preference stock shall be entitled to a sum equal to the average price at which the

stock has been sold in two preceding years, but not less than par. R. and J. Dick, an English concern which does an extensive business in the United States in boots, shoes and belt-ings, provides that in the event of dissolution the preferred shares shall have a prior claim up to their par value, plus a sum equal to the average premium at which the shares may have been quoted at Glasgow during the three years preceding dissolution.

General Characteristics of Preferred Shares

From the various examples that have just been cited, the reader may construct a composite picture of preferred share issues. He will find that they range in their fixed dividend rate from as low as 4% to as high as 10%, with a marked preference among industrials for 7%. He will find that a great majority either are irredeemable or are redeemable at the option of the corporation, and that a small number are protected by sinking funds and by other provisions which make them, for all practical purposes, obligations of the corporation.

In the United States comparatively few preference shares are given voting power. In England, and more especially in Canada, the custom is just the reverse. It is, however, becoming more and more common in this country to give preferred shares some contingent voting power so that they may assume control, or at any rate exercise some influence, in case of default of payment of their regular dividends. There are many preferred shares that have some claim on dividends above their fixed rate; these are known as "participating preferred" shares. Special provisions regarding convertibility and redemption are found here and there. In general, it should be noted that shares may be preferred in a great many different respects and forms, and that it is therefore necessary to study each instance of preference separately.

Special Forms of Shares

There are many peculiar varieties of capital shares which do not come definitely within the two main classes, common and preferred, or which have notable features. In Great Britain it is a common practice to compensate the organizer of a corporation by giving him a final claim on earnings which is valid only after all the claims of those who have furnished capital have been fully met. The shares which represent this claim are variously known as "founders' " shares, "management" shares, and "deferred" shares. Although this practice is frequently condemned, it seems at least as defensible as the custom in the United States in accordance with which the promoter of a corporation retains by way of compensation, as much as he can of the common stock. Deferred, management, or founders' shares in England are usually of very small par value—most commonly, one shilling per share. In case the corporation succeeds in fulfilling the expectations of its organizer, the founders' shares may come to receive large dividends and to possess a high market value altogether out of proportion to their nominal value. Indeed, there are instances in which separate companies have been formed in order to hold the founders' shares and distribute interest in them in a more convenient manner. A slightly different plan was followed by the holders of the founders' shares in the original Suez Canal Company. There were 100 of these shares which were of no par value but which were entitled to 10% of the surplus profits. These 100 shares were divided into 100,000 and were sold on the open market. The customary arrangement is that founders', management, or deferred shares shall take one-half the profits remaining after the ordinary shares have received a given rate of dividend.

Sometimes voting shares are subjected to peculiar restrictions for the sake of forestalling any danger of losing control or of bringing into the management people who are not de-

sired. The Imperial Tobacco Company, Ltd., which is a combination of the chief British manufacturers of tobacco, has but three or four hundred holders of its voting shares and is controlled by a much smaller number. In order to maintain its character as a "close" corporation, it has stipulated in the articles of incorporation that no shareholder may dispose of his shares except by offering them, through the company, to other shareholders at a price to be fixed by the shareholders from time to time. An exception is made with respect to the transfer of shares to members of the immediate family of a shareholder. The price fixed for transfers has always been considerably less than the probable market value. In 1912, for instance, when 3% dividends were being paid, the price fixed was £2. In 1913, when 35% dividends were being paid, the price fixed for these transfers was increased only to £2 5s.

In the United States small, close corporations sometimes attempt to accomplish the same result by means of by-laws prohibiting the sale of stock to anyone not already a stockholder, or prohibiting the sale of stock without the consent of the directors, or unless it has first been offered to the directors at a price not greater than that at which it is subsequently to be offered or sold to outsiders. These provisions, however, are illegal and unenforcible. Nevertheless they are sometimes adopted, and printed on the face of stock certificates to give notice that outside purchasers are not welcome, and that whatever rights they may obtain they will be able to enforce only through legal process. Sometimes stockholders agree among themselves to withhold their stock from outsiders. Such a contract would be legal as between the stockholders, but would not affect the rights of any outsider who might without notice and in good faith purchase some of the stock. On the whole, it may be said that restrictions of this nature have not proved effective in this country.

The Montana Power Company has two classes of common stock. About \$27,000,000 is receiving 2% dividends, while dividends on \$22,500,000 are "deferred" until certain new plants are completed, and are then payable only gradually over a series of years. Inasmuch as the New Jersey laws, under which the company is incorporated, do not authorize the payment of dividends on part of an issue unless they are paid on the whole issue, this arrangement seems at first glance illegal. In response to an inquiry, however, the treasurer of the company advises that:

The stockholders owning \$22,500,000 of the stock of this Company have agreed that, as to their stock, dividends may be deferred until a certain time, and that stock has been conveyed to certain trustees, who hold the same for the purpose of securing the provisions of the agreement with regard to deferred dividends. As any part of the stock becomes entitled to dividends, it will be released from the provisions of the trust agreement and will be distributed to those who are entitled to receive it.

It appears, therefore, that this issue of "deferred" stock—the term was previously almost unknown in the United States—is made possible solely by voluntary agreement among certain stockholders.

Another issue which is unusual is the "assenting" stock of the Westinghouse Electric and Manufacturing Company. This is an outgrowth of the reorganization of the company, in 1891, at which time the common stockholders were asked to surrender 40% of their holdings and retain 60%. This 60% was to be called "assenting" stock, and was to receive 7% preferential dividends before the other common stock, no part of which was surrendered. In other words, the "assenting" stock became practically a second preferred and might have been so designated.

Certificates of Stock

A certificate of stock and the stock itself are two different things. The certificate is in the nature of a receipt. It certifies that a given individual is the owner of so many shares, and usually gives a brief digest of the special conditions, or terms, if there are any, which govern these shares. The certificate may be destroyed or lost, but neither contingency would in itself affect the ownership of the shares, or even the legal evidence of ownership which consists of the company's own register of stockholders and of the amount of their holdings. The loss or destruction of a certificate could ordinarily mean, therefore, only so much inconvenience.

There are numerous technical questions with regard to the handling of stock certificates and the transfer of ownership of stock through delivery of certificates, which can only be touched upon here. In one recent case a stockholder had left his certificate, indorsed in blank, with a broker for safe-keeping. The broker fraudulently sold the certificate. It was pointed out by the courts that if the purchaser actually was innocent and was acting in good faith, he had received a good title, and that the presumption would be that he relied upon the indorsement made by the owner, inasmuch as such indorsement would be *prima facie* evidence that the owner intended to give the broker the right to sell the stock. If the certificate had been left without being indorsed, and no power of attorney had been given the broker, so that he would have been compelled to forge the name of the owner, the purchaser would not have secured a clear title.

A question frequently raised is, what is to be done when a stock certificate is lost? The secretary or transfer agent of the corporation should be immediately notified not to transfer it on the books of the corporation. It is usually difficult to procure another certificate, because the corporation must be protected against loss by the filing of a bond, and this bond

must be kept in force so long as there is a possibility that the old certificate may turn up. Every state has its own statute of limitations showing how long an obligation of this kind is to be regarded as legal and enforcible. The important point that should be kept in mind in connection with all such matters is, that there is an increasing tendency, which nearly all decisions show, to make stock certificates strictly negotiable instruments, and as such transferable by indorsement without its being necessary to give further proof of ownership. It must be remembered that the holder of record of a lost certificate can vote and receive dividends as before. The loss of his certificate affects only his power to transfer his stock.

As has been indicated, stock certificates of the larger corporations in the United States are always "registered," that is to say, the list of stockholders of a corporation is kept in a register, and transfers from one name to another are made on presentation of the stock certificate properly indorsed. In England a comparatively small amount of stock is "inscribed." In this case the holder is given merely a stock receipt, which has no special value or importance. Whenever it is desired to transfer stock holdings the owner must appear in person, or in the person of some one legally entitled to act as his attorney, at the office of the corporation and there attest the transfer by signing his name in the transfer book. This is too cumbersome a method to be practicable except for small or close corporations.

A third form in which certificates may be issued is the "bearer" form. In the United States there are few, if any, bearer certificates of stock. In England they are used for preferred, guaranteed, and debenture stocks when the rates of dividend or interest are fixed, and when there is a definite date of redemption. Inasmuch as the ownership of bearer securities is not registered, the certificate itself is the sole evidence of ownership and must therefore be guarded with

great care. Ordinarily, coupons (which are, in effect, a series of post-dated checks, one for each interest or dividend payment) are attached and must be cut off and deposited for payment at the proper time.

Par Value of Shares

The par value of shares of stock may vary in any amount from as low as one cent to as high as thousands of dollars. In some states the minimum par value is fixed at \$1, \$5, or \$10, as the case may be. Nearly all shares in the United States are \$100 or less, with an overwhelming majority fixed at \$100. The next most popular figure is \$50, and then probably \$25, \$15, and \$10. In recent years the tendency to issue shares without par value has grown stronger and stronger.

There is also a tendency, which appears to be growing in strength, to reduce the par value of shares of many corporations that are looking for wide distribution of their stock, and especially of those corporations that desire to have their own employees become interested in the company as stockholders. It is said that during a visit to England in 1913 George J. Whalen, president of the United Cigar Stores Company, was much impressed by the fact that most English industrial and commercial shares have a par value of £1 or £2. Under his influence the par value of the United Cigar Stores stock has been changed from \$100 to \$10, the par value of the stock of the Corporation of Riker-Hegeman from \$100 to \$5, and the shares of the United Profit Sharing Corporation were brought out at a par value of \$1. A number of important companies like the National Transit Company and the Eastern Steamship Company have made the par value of their shares \$25.

On the other hand, there are a number of instances of closely held shares which have an exceptionally high par value.

Lalance and Grosjean Manufacturing Company, a New York corporation, has common stock of a par value of \$500. The par of the stock of the Tribune Association, the company which publishes the *New York Tribune*, is \$1,000. The par value of the stock of Tiffany and Company is also \$1,000.

Issue of Shares—Full-Paid and Partly Paid Shares

The theory of the law is that all corporate securities are issued in exchange for cash, or other value, equivalent at least to the nominal value of the shares. If shares are issued without proper consideration, they may be cancelled as invalid. An important case in point was decided in the State of New York in 1912. It appears, according to testimony, that at the time Henry O. Havemeyer was president of the American Sugar Refining Company, he undertook, in behalf of his company, to purchase shares of the National Sugar Refining Company and otherwise to help finance that concern. In return for his services he received \$10,000,000 of the common stock of the National Sugar Refining Company. When suit was brought against his estate several years later for cancellation of this issue, it was decided by the courts that insufficient consideration had been received, and that the whole issue should be declared void.

Some governments will not permit payment for stock to be made in anything except cash. The State of New Jersey allows payment in cash and property, excluding services. These limitations, however, are of no great practical importance, for it is a very simple matter to arrange for an exchange of checks which will satisfy the technical requirements of the law and at the same time accomplish the identical purpose that would have been accomplished if property or services had been directly accepted in payment for the stock.

In this country stock is seldom issued for less than its par value, and is seldom allowed to remain permanently "partly

paid." In England partly paid shares are common, especially in banking corporations. In this case the unpaid portion of the shares remains as a liability of the shareholder and is therefore a source of strength to the institution. In both countries, with very few exceptions, shares that are issued for cash, property, or services valued at less than the par value of the shares, carry with them an obligation on the part of the holder to pay up the difference at any time that the corporation—or the receiver for the corporation if it should become insolvent—may call upon him to do so. This liability does not, however, extend to an innocent holder for value.

A *bona fide* purchaser for value and without notice of stock issued by a corporation as "paid up" cannot be held liable on such stock in any way, either to the corporation, corporate creditors, or to other persons, even though the stock was not paid up as represented. Such a purchaser has a right to rely on the representations of the corporation that the stock is paid up.*

Partly paid stock may at some later date be made full-paid if the corporation prospers and accumulates a sufficient surplus to enable it to declare a stock dividend equivalent to the unpaid portion of the shares. Some time ago one Utah corporation, the stock of which had been only 20% paid, found itself in a position to declare an 80% stock dividend. There was probably no doubt about the legality and the propriety of this procedure. The corporation's surplus was genuine, and it was much better for the shareholders to be relieved of their obligation than to continue to carry so much of a surplus account.

Under certain conditions shares may be sold by a corporation below their par value and still be regarded as full-paid. The chief condition is that the corporation shall be in need of

*Cook on Corporations, §50.

funds and shall not be able, with reasonable effort, to dispose of its shares at or above their par value. In the same way an insolvent corporation may be permitted to issue some of its shares, in payment of its debts, at a price below the par value of the stock.

Bonus Shares

A question which often arises is that of issuing common stock as a bonus in connection with bonds or with preferred stock. It is common practice, for example, to sell the bonds of industrial and public utility companies at par with a 10%, 20%, or some other percentage bonus of common stock. On the surface it appears that the stock is being given away, and that the purchasers and subsequent holders must assume a liability to pay its full par value on demand. Ordinarily, this offer is made, not directly by the corporation, but by a firm of bankers or brokers which has probably secured the common stock according to part of a contract which includes compensation for their own services; the stock has thus been made "full-paid." Even when the purchase is made direct from the corporation, however, it may involve no liability on the stock; for technically the purchaser is supposed to pay the full par value of the stock and to take the bonds at a discount. In most of the states there is no statutory or common law which prevents the sale of the bonds or other obligations of a corporation at a discount. When common stock is issued as a bonus with preferred stock, the case may be different. Under such circumstances there are technical points which are variously interpreted in different jurisdictions. In the State of Washington, the Supreme Court has recently decided that persons receiving shares of common stock as a bonus with preferred are liable for the par value of such stock, the acceptance of the bonus stock carrying an implied promise to pay for it if payment is called for.

Watered Shares—Overcapitalization

While it may seem that the corporation laws almost without exception prohibit the issuance of full-paid shares for less than the equivalent of their par value, and that it would be impossible, therefore, for a corporation to start out with a capitalization higher than the actual market value of its property, it is well known that in actual practice this law is frequently ignored.

The capitalization of many corporations does not correspond, or even tend to correspond, closely to the value of their assets. How is it possible to introduce this overcapitalization—or “water,” as it is sometimes called—without acting directly in opposition to the law? The answer is to be found in the process of placing a valuation on the property or services acquired by the corporation. It is, of course, impossible to place an overvaluation on cash payments for stock. It is difficult to place an excessive overvaluation, even if it should be desired to do so, on tangible property that is accepted in payment for stock; such property is for the most part of fairly stable and easily ascertainable value. But in the valuation of intangible property—good-will, patents, trade-marks, copyrights, organization, and the like—and in the valuation of special services, there is every opportunity to fix any figure that may be desired by the organizers of the corporation. It is not necessary to assume a wilful falsification of values in every instance in which a corporation is later shown to have been overcapitalized. Organizers are likely to be sanguine men who sincerely believe, at least for the time being, that the property they are acquiring has a remarkable potential value. By means, therefore, of the simple device of issuing stock for intangible property and services at whatever valuation the directors of a corporation agree upon, it is possible to adjust the capitalization of the corporation to suit the ideas and interests of the organizers of the corporation.

The promoter of a mining company, to imagine an extreme case, thinks it possible to sell \$1,000,000 par value of stock provided he can offer it at a heavy discount, say 10 cents on the dollar. His first step after incorporating his company is to procure a piece of property that may be represented as a prospective mine. He places a valuation of \$1,000,000 on this property and sells it to the corporation—the directors of which are his own “dummies”—for \$1,000,000 par value in stock. The promoter is then ready to sell his stock to the public at any price he may see fit to put upon it. The stock has been made full-paid because it has been issued for property which the directors have declared to be worth \$1,000,000. This assumed transaction would probably be purely fraudulent. The same principle, however, is applied in organizing many legitimate corporations.

For instance, at the inception of the United States Steel Corporation, all the preferred and common shares, as well as its 5% gold bonds, were turned over to a syndicate of bankers headed by J. P. Morgan and Company, in exchange for \$25,000,000 in cash plus the stocks and certain bonds of the seven corporations which were at first taken into the combination. In view of the fact that some of the seven companies acquired had a considerable amount of water in their own capitalization, and inasmuch as the \$1,300,000,000 stocks and bonds received by the syndicate had a much higher value than the market value of the stocks and bonds of the subsidiary companies, it is clear that the Steel Corporation started out with a large amount of water in its capitalization. The estimate of the market is shown by the fact that the common stock at first sold in the neighborhood of one-third of its par value. In this case the directors were free to place their own valuation on the securities of the subsidiary corporations which they acquired, and more especially on the services rendered by the syndicate which carried through the whole transaction,

As reference will be made from time to time in this volume to numerous other instances of overcapitalization, no further examples need be cited here. It may be remarked in passing, however, that the basic theory of the law that capitalization should always correspond to the actual market value of the assets of a corporation is, in the judgment of many competent thinkers, both impractical and unsound.

It may be asked why the courts do not more frequently enforce a closer adherence to the intent of the law. The answer has already been partly indicated. The intangible assets and the services which are accepted by corporations in payment for their stock are difficult to value, and for this reason it is only in exceptional cases that bad faith on the part of corporations in making their valuations can be conclusively shown. On the numerous occasions when this question has been involved, the courts have applied either one or the other of two rules, known respectively as the "true value" rule and the "good faith" rule. The true value rule, which has been applied in a number of instances during recent years by the courts of Maine and New Jersey, is to the effect that in case a wide discrepancy between the market value of property and the par value of shares for that property can be shown, it may be assumed that the directors were misinformed; hence the shares issued for that property are not "full-paid," and the holders of these shares may be sued for the difference between the real value of the property and the par value of the shares they received. In a New Jersey case, in which the owner of a patent had received \$1,000,000 in stock for his contrivance, after the owner's death his estate was found to be liable to the corporation for approximately \$900,000. The other rule, which was formerly universal in the United States and which is still commonly applied, indicates that directors may be assumed to be acting in good faith and with proper information before them unless fraud

can be conclusively shown. It is well known that it is always a difficult matter to produce legal evidence of fraud.

Shares without Par Value

In view of what has just been said concerning the issuance of watered shares, it is clear that there is no necessary or even close relationship between the par value and the market value of the shares of many corporations. A glance at the daily list of sales on any stock exchange will substantiate this statement. In order to avoid all question in regard to overcapitalization and undercapitalization and concerning the value of property acquired in exchange for shares, a considerable number of corporations have adopted the plan of issuing shares without par value. The company makes no claim, either expressed or implied, as to the value of the assets. Its balance sheet shows, instead of capital stock and surplus, simply the value of the equity which is divisible among the shareholders. Anyone interested, if he knows the number of shares outstanding, may figure for himself the book value of each share. This method furnishes probably the simplest and most satisfactory means of handling the whole question of capitalization and of valuation of property and services. Among the corporations which have adopted this system are the following: the Submarine Boat Corporation, which was chartered in New York in August, 1915, with 800,000 shares of no stated par value; the Kennecott Copper Company, which is understood to be a Guggenheim enterprise; the Adams Express Company; the Amoskeag Manufacturing Company; and Montgomery, Ward and Company.

Methods of Voting

In the United States the well-established custom is to allow, for every share of voting stock, one vote in the election of directors and in the decision of other questions that come

before shareholders. As a result, the larger shareholders exercise almost complete control. Not only do they possess the greater number of shares, but they have a large enough financial interest at stake to make it worth while for them to take an active part in the affairs of the corporation. The small holder, on the other hand, feels that he can exercise no real influence, and that it is not worth his while to attend meetings or even to send in a proxy, or written authorization, to some officer or other person present to act for him.

In the United States Steel Corporation those shareholders who own 1,000 or more shares each, have in the aggregate a larger number of votes than the vast majority of smaller stockholders. It is safe to assume, therefore, that even in so large a corporation these comparatively few men are the ones who are keenly and directly interested as shareholders, and take the trouble to try to elect directors who will represent their views. It is for this reason, primarily, that in the United States complete control of a corporation may be obtained by one man, or by a group of men, who own perhaps only a small percentage of its outstanding stock. This has been notably true of some of the large railroad systems. It is stated that at the time when George J. Gould was in undisputed control of the Wabash and the Missouri Pacific railroads, he and his family never had more than 12% of the outstanding stock. It is said that the control of a bank or a trust company may, under ordinary conditions of stock ownership, be retained by the holders of 30% of the outstanding stock.

In English practice a different principle as to voting is customarily, though not universally, followed. In order that complete domination by the large shareholders may be prevented, a limitation is placed on the number of votes that may be cast by any one shareholder; or, instead, a regressive scale is so arranged that the number of votes does not increase in proportion to the number of shares. This practice dates back

several generations. The "Companies Clauses Consolidation Act" of 1845 provides that whenever no scale of voting is prescribed in the by-laws, every shareholder shall have one vote for every share he holds, up to 10; an additional vote for every 5 shares, up to 100; and an additional vote for every 10 shares beyond 100. The Sheffield United Gas Light Company allows a shareholder not more than 30 votes; the London Gas Light and Coke Company, not more than 10 votes; the Bristol United Gas Light Company, not more than 5 votes; the Black Pool Tower Company, not more than 20 votes. It is said that attempts to evade this restriction are uncommon and that attempts to purchase control of established corporations in order to bring about combinations, and for other purposes, are not nearly so frequent in England as in this country. There are obvious advantages in this practice that are well worth considering, particularly those that have to do with the enlistment of the active interest of the smaller shareholders and the interposition of obstacles to exploitation. It is quite possible that the practice might be adopted to advantage, especially by local corporations which may have meetings of shareholders from time to time, and in which the personal influence of these shareholders is of real importance and value.

Cumulative Voting

The obvious injustice and danger of permitting the holders of a majority of the voting stock—or rather, in many cases, the officials and others who can most easily procure for themselves the right to represent the majority of voting stock—to elect all the directors, and thereby to take full and unrestricted control into their own hands, has led to the growing popularity and the very general adoption of another method of voting: namely, the cumulative method.

Cumulative voting may be defined as a method whereby

each shareholder may cast as many votes as he holds shares of stock, multiplied by the number of directors to be elected. A shareholder may cast all of his votes for one, or two, or more candidates, or he may distribute them in any other proportion he sees fit. Thus the minority shareholders may so combine and concentrate their votes as to make certain of electing one or more representatives to the board of directors.

To illustrate, let us assume that a corporation has 1,000 shares outstanding, 600 of which are in the hands of a majority party, and that five directors are to be elected. Under the usual system of allowing one vote to each share and voting for each director separately, the majority shareholders may pick out the full board of directors without any reference whatsoever to the wishes or interests of the minority. Under the cumulative system of voting, the majority party would have 5 times 600, or 3,000 votes altogether, at their disposal, and the minority party would have only 2,000 votes. If the majority party should attempt to elect all five directors, they could give only 600 votes to each one of the five; the minority party could meet this move by concentrating their 2,000 votes on three directors, giving each one 666 votes, and thus elect a majority of the board. In order to make themselves secure, the majority party, presumably, would concentrate on three directors, each one of whom would get 1,000 votes; and the minority party would concentrate on two directors, each one of whom would receive 1,000 votes. Each party would thus secure representation on the board in exact proportion to its shareholdings in the corporation. In practice the situation would never be quite so simple, but the result of giving representation in approximate proportion to shareholdings would be obtained.

There appears to be no question but that cumulative voting tends to prevent injustice and exploitation, and that it leads to a more active interest on the part of the smaller share-

holders, who have under this method a better chance to secure representation. Among the large companies which have adopted cumulative voting are the Anaconda Copper Mining Company and the Ingersoll-Rand Company. Cumulative voting is permitted by the laws of practically all the states, and is specifically required in some, including Pennsylvania and Illinois.

Stockholders' Meetings

The larger corporations in the United States make it their custom to send out notices of annual meetings to all stockholders, and to forward with these notices a printed proxy, which authorizes the secretary or some other officer of the corporation to represent the shareholder at the annual meeting. Most of the corporations supply stamped envelopes and, if they do not hear from the shareholder, forward a second request for his proxy. All that the shareholder is asked to do is to sign his name, enclose the proxy in the envelope and mail it. Nevertheless the interest on the part of the average shareholder is so slight that only a small proportion of these proxies, it is stated, are ordinarily returned. It is easy enough to return the proxy, but it is just a trifle easier to drop it into the waste basket. Probably the average shareholder sees no reason why he should take action one way or the other. He does not know whether the corporation is being well-managed or whether the officers and directors deserve his support or not. Except in very unusual cases, when there is an opposition and when a campaign to get his support is carried on, he knows that his vote will have not the slightest influence either for or against any man or measure.

Usually the secretary and one or two other officials of the corporation take the proxies to the annual meeting, go through all the formalities of electing a chairman and a secretary, presenting reports and casting votes, and carry out whatever

programme has been agreed upon by the officers of the corporation. Every year, for instance, an officer of the Union Pacific Railroad Company takes a satchel full of proxies, makes the trip from New York to Salt Lake City (the Union Pacific Railroad Company being incorporated in Utah) and holds the annual meeting. Even when action out of the ordinary is proposed, very few shareholders ever take the trouble to attend these meetings.

At the annual meeting of the Northern Pacific in 1914, authority was asked for a new issue of \$750,000,000 in bonds. Some of the shareholders objected to the looseness of the authority asked, but the plan was carried through without effective opposition by voting the proxies previously collected by the officers. An amusing account of this meeting appeared in the *New York Annalist* of June 15, 1914, from which the following paragraphs are quoted:

Eighteen shareholders, one for every one thousand stockholders, were on hand to see that justice was done to their interests. Four of these were directors, one was Chairman of the Board, another a former Vice-President; . . . but the strength of the meeting was not in the number present. When the Secretary took his place, he brought with him proxies for 1,387,202 shares of stock—nearly 56% of the total outstanding. The stockholders might have talked their heads off, and voted as a unit against the bond issue, and still it would have gone through when the Secretary put down 1,387,202 shares in its favor.

Colonel Clough (the Chairman of the Board) sat in a high-backed chair at the head of a long table, looking an embodiment of the spirit of impartiality. . . . He had a courteous manner for each speaker, and in the pile of proxies he had a steam roller to run over objections when it came to a vote.

After the reading of the resolution, Christian F. Leng arose to call attention to a small omission in the resolu-

tion. Not belligerently, but as one seeking to correct an oversight, he asked the Chair to state the amount of the proposed mortgage. He characterized the resolution as somewhat vague on that, to him, important point.

The Chair was sorry the gentleman did not understand corporation matters better. The amount was to be left to the wisdom of a Board of Directors chosen by the stockholders to safeguard their interests. They would study the matter from every angle, lunch over it, and sleep on it, and in the course of time arrive at the total.

It seemed that Mr. Leng was inclined to be stubborn. He said the Chair evidently had failed to understand his question, which had nothing to do with the province and wisdom of Directors, but concerned the amount of the proposed mortgage. As the owners of the corporation, he thought the shareholders entitled to know from their agents the amount to which they proposed to bond the property. "Is it not a reasonable inquiry to ask how much you propose to make this mortgage?" he concluded.

The Chair again set about the enlightenment of the Philistine. Patiently he explained that were the stockholders to determine the amount of the mortgage they might be kept in session for several days. That was a task for the Directors, a labor which the shareholders should be glad to escape. The Directors were in office solely to look after the interests of the stockholders. They would canvass the situation, look at it by and large, dig into figures, and attempt a forecast of the future. The Chair was a master of circumlocution, and always patient.

Arose Mr. Leng again, to say that when he put a mortgage on his property he did not give a lawyer *carte blanche* to make it as large as he could. He suspected that the management had already decided on a figure; what he wanted to learn was the figure. To which the Chair replied that the Directors could be trusted to do what was right in the matter.

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The meeting having lasted as long as conventional shareholders' gatherings should continue, the steam

roller was started gently. A vote on the original resolution was called for. On the proposition to authorize the Directors to proceed with their plan, the Secretary announced: "Against, 400 shares; in favor of, 1,387,700." The meeting was adjourned.

Voting Trust

The "voting trust" has been growing in favor during recent years. It has already been mentioned that at one time, a generation or more ago, the favorite form of combination among competing concerns was a body of trustees to whom controlling shares in the competing corporations were turned over—an arrangement found to be in restraint of trade and therefore illegal. The plan herein referred to is different, in that it is confined to one company and its sole purpose is to secure continuity of management and policy within that company.

The laws of most states which authorize the formation of a voting trust require that it shall be open to all shareholders who wish to take part in it. Without this provision it might become a dangerous device for concentrating control. In fact, even with this restriction there is reason to think that the voting trust has sometimes been used rather for the benefit of the trustees than for the benefit of the corporation.

The chief use—and a legitimate use—of the voting trust, however, is to protect the shareholders and others who take part in a reorganization. Ordinarily, as we shall see later on, a reorganization is carried through by a banking syndicate, headed by some powerful banking firm. Naturally the firm, in order to protect its own reputation and the people to whom it has sold the securities of the reorganized company, wishes to make sure that there will be sound management over a period of years. Yet it is not in control and perhaps holds very little of the company's stock. In order to meet this situation, it is frequently required that a majority of the voting

stock be lodged with trustees under a voting trust agreement. Stuart Daggett states that out of seven railroad reorganizations, during the period 1893-1898, five included voting trusts and one a proxy committee in the reorganization plans.

A similar use of the same plan is the establishment of a voting trust representing the preferred shareholders when there has been default in payment of the preferred dividends. Under the laws of New Jersey, a voting trust cannot continue for longer than five years, and other states have imposed similar limitations. Ordinarily, the trustees have an option to terminate the arrangement at their discretion. When the Northern Pacific voting trust was dissolved in 1901, the trustees explained the dissolution: "by reason of the evidence of financial strength, conservative management, skilful and profitable operation, superior physical condition of the property and reasonable prospect of continued prosperity."*

Still another use of the voting trust is to prevent the control from passing into the hands of interests that are not regarded favorably by the management of the corporation. When the American Glucose Company was formed, in 1894, the vice-president of the company controlled a clear majority of the stock, but it was agreed, nevertheless, that the active management should be in the hands of the president. An agreement was therefore signed "to place in the hands of trustees, to be named by the President, 2,544 shares of said preferred stock, upon the trust that in the election of the directors and officers of said company, and upon other matters arising at stockholders' meetings, said trustees shall vote thereon as requested by said President." The addition of the trustees' stock to the president's own holdings gave him control of the company and enabled him to elect four out of the seven active members of the board.

Among the various important corporations in which there

*Stuart Daggett's "Railroad Reorganizations," p. 310.

are now voting trusts, may be mentioned the Buffalo Electric Vehicle Company; William Cramp and Son, Ship and Engine Building Company; General Motors Company; Intercontinental Rubber Company; International Mercantile Marine Company; Lehigh Coal and Navigation Company; J. I. Case Threshing Machine Company; Loose-Wiles Biscuit Company; Hale and Kilburn Company; and Allis-Chalmers Manufacturing Company.

Among smaller corporations the voting trust is somewhat unusual. In many cases it might be found a legitimate and helpful means of securing agreement and continuity of policy.

CHAPTER VI

BORROWED CAPITAL—SHORT-TERM

Advantages of Borrowing

"The habit of borrowing," says Hartley Withers, "is a modern invention." There was formerly a custom among all well-ordered governments and business enterprises, of amassing treasure for use in emergencies; without hoarded treasure even the largest owner of property would have been helpless. Today the wisest financial policy is to pile up not treasure, but credit. To be sure, sound credit may require the possession of a certain proportion of gold and securities; but this treasure no longer exists for its own sake so much as for a support and guarantee to credit.

More and more as credit facilities increase and credit machinery works more smoothly, business enterprises are financed with borrowed capital. The great advantages of borrowing are its cheapness and its ease. It is cheaper to borrow than to secure a co-owner or a group of co-owners for a business, because of the greater security that is offered to the lender. To put the same thought in terms of corporate financing, first-class bonds may be sold on a 4, 5, or 6% basis, whereas preferred shares sell on a 6, 7, or 8% basis, and common shares on a still higher basis. Hence, the larger the proportion of capital which the individual or corporation can borrow, the larger is the yield on the owned capital.

Take a very simple illustration. Suppose a corporation with \$100,000 capital is regularly earning 10%, or \$10,000, a year; let us say that \$20,000 of the capital is borrowed at 5%, making the interest payment \$1,000. Then the \$80,000 of owned capital will have left an income of \$9,000, or a

little over 11%. Let us now make the assumption that the business is of such a character that \$80,000 can be borrowed at 5%, making the annual interest payment \$4,000. In that case the \$20,000 of owned capital will have left an income of \$6,000, or 30%.

We have here an explanation of the profit-making possibilities—when properly financed—of enterprises which yield only a small average return on the invested capital. Most public utility companies, for instance, secure only a moderate yield on their actual investment, but these companies hold properties which can be mortgaged up to a high percentage of their value. Hence, at least one-half the capital is borrowed and the owned capital may obtain very good dividends. According to the *Electrical Railway Review*, the issued stock of all the electrical railways in the United States for 1912, had a par value of \$2,945,000,000, and for 1913, \$2,808,000,000, a decrease of \$137,000,000. The bonded indebtedness of these companies for 1912 was \$2,641,000,000, and for 1913, \$2,814,000,000. We see here not only a large proportion of borrowed capital, but its rapid increase from year to year, with a corresponding decrease in owned capital. The same thing is true of real estate operations. An extreme case is that of a New York corporation known as the "Forty-two Broadway Company," which has a capital stock of \$600 and a bonded indebtedness of nearly \$5,000,000.

As to the ease of borrowing, it is perhaps sufficient to call attention to the immense quantities of bonds and notes which are continually being issued and sold. Modern efficiency and productivity are piling up wealth at a faster rate than ever before. And the security of property—except as it may be disturbed by tremendous international conflicts—is increasing. Now the first thought of a man who has only a little money is to increase that little, and he is willing to take chances in so doing. For that reason, it is among poor people, and

especially poor people of the professional classes, that the swindling promoter finds his easiest victims. But a man who has a comfortable amount of property is looking for safety rather than for increase. Hence, as the average wealth of a country increases, not only is more and more capital released for investment, but a larger proportion of that capital is looking first of all for safe investment. In other words, its owner prefers to lend it rather than to take greater chances as a proprietor or part proprietor.

Another factor working in the same direction, is the piling up of enormous funds held in trust; estates that are being directed by trustees; the funds of life insurance companies; the funds of savings banks and the like. All these trust funds are available only for lending on excellent security. For these reasons a man or a corporation who can put enough owned capital into a substantial enterprise to furnish a reasonable margin of safety, will generally find it a comparatively simple and easy task to borrow the remainder of the needed capital.

What has been said applies more especially to long-term or "funded" borrowing, but much the same statements hold true on short-term borrowing. "Through all business activities," points out the *New York Annalist*, "there is more capital needed today than used to be needed, but it is wrong to take it for granted that an individual needs to have more money to go into business."*

The explanation for this apparent paradox is to be found in the free use of credit which is a striking characteristic of all present-day business enterprises. Manufacturers, wholesalers, and bankers are always ready to extend credit freely to young men of ability and character. The silk industry is notable for the amount of business that can be done on a very slim margin of capital. Raw silk is sold to manufacturers on a credit basis that resembles "memorandum credit" among

**New York Annalist*, April 17, 1914.

jewelers. Many factories are rented entire. It is said that in Philadelphia the extensive cotton industry is in large measure carried on in the same way. Lofts with power and machinery are rented; materials are obtained on a credit basis. The United Shoe Machinery Company has for many years made a practice of furnishing its machines only on lease; it does not sell them. In this industry, therefore, a man with large capital has no great advantage, so far as obtaining efficient machinery is concerned, over a man with small capital.

Proportions of Borrowed Capital

In England the distinction between preference shares and "debenture" shares or other forms of obligation, is so hazy that owned capital almost imperceptibly merges into borrowed capital. Partly for this reason, the proportion of borrowed capital often appears somewhat smaller than in this country. For example, in water, railway, tramway, gas, and other public utility companies, the amount of loaned capital is usually limited to one-third of the total capital. The Board of Trade in railway returns for 1910 showed percentages of the various classes of railroad securities as follows:*

Ordinary stock.	37.3%
Preference and guaranteed stock.	35.8%
Loan and debenture stock.	26.9%

It will be noted that much of the preference and guaranteed stock would normally be considered as borrowed capital in this country, so that actual practice in the above classes of undertakings does not differ much from the practice in the United States.

The first schedule of the English Companies Consolidation Act of 1908, provides that the indebtedness of a company shall

*Robert H. Whitten's report on "Regulation of Public Service Companies in Great Britain," issued by the Public Service Commission, 1st District, State of New York, 1914, pp. 26 ff.

not at any time exceed the amount of its capital without the sanction of the shareholders in general meeting.

Against the two great advantages of using borrowed capital—cheapness and ease in procuring the funds—there must be offset the obvious disadvantage, that the risk to the owners of the share capital is thereby increased. The shareholders have, of course, only an equity in the property and income of the corporation which is first subject to all prior claims of the holders of the obligations. This may not involve a serious risk in the case of corporations that have stable earnings, but when earnings fluctuate widely from year to year, even though the average return on the invested capital may be high, the position of the shareholders with a large indebtedness ahead of them may become very uncomfortable. It is for this reason that the tendency has been strong in recent years for industrial corporations to shun even small bond issues and to raise their capital only through common and preferred shares. Sometimes this cautious policy may be carried to what appears to be an extreme. Two large and powerful industrial corporations, for instance, the Pullman Company and the Singer Sewing Machine Company, have no securities outstanding except common stock. Two somewhat smaller corporations which have cleared away all their obligations, including even short-time notes and accounts, are the Plume and Atwood Manufacturing Company, in Connecticut, and the United Shoe Machinery Company.

The unsoundness of too heavy borrowing cannot be better shown than by the combined figures on the capitalization of thirteen large railway systems in the United States which were in receivers' hands in the summer of 1914. The funded debt of these thirteen railways was about 70%, and the stock issues only about 30% of their total capitalization.

To lay down any exact rules as to the proper proportion of borrowed capital, would clearly be out of the question. We

are forced to fall back on the general statement that capital should not be borrowed unless there is a practical certainty that both interest payments and payments on principal can be met as they fall due. This involves the further rule that the annual fixed payments of a corporation should be only a reasonable proportion, not of the average earnings, but of the lowest earnings. The fact that a corporation has made a distribution or invested big profits in one year, is small comfort if it finds itself in the following year unable to meet its obligations.

As to payments on account of principal, it has long been regarded as almost axiomatic that companies doing a stable business, such as railways and public utilities, need make no provision for paying off and retiring their funded debts. These companies, it has sometimes been said, will never cease to borrow; therefore, when one obligation matures, the proper plan is to refund it by issuing another obligation in its place. However, this principle is no longer universally accepted. In fact, at the 1915 meeting of the Investment Bankers' Association, the Committee on Railroad Bonds and Equipment Trusts recommended among other things that railroad mortgages should contain provisions for sinking funds. Even railroad corporations, if this recommendation were generally adopted, would be taking steps to pay off in cash each obligation which they incurred.

Forms of Borrowing

All borrowing is of two general classes, "short-term" and "long-term." This is by no means purely a verbal difference, for there are clear market distinctions between the principles that apply in these two classes. Just where we should draw the line between the two is a difficult question to answer; it is largely a matter of usage. In Wall Street, "short-term" usually refers to obligations having not more than five years

to run; "long-term" usually refers to obligations having, say, twenty years or more to run from date of issue. Obligations running in intermediate periods might be put in either one or the other of the two groups. The question is not of much importance; for apart from the securities known as "equipment notes," there are very few which fall within the five-year to twenty-year limits. The chapter which follows will be devoted to "long-term" securities, so that nothing more need be said about them here.

Short-term securities consist of notes, of acceptances, and of accounts payable. The notes are divided into three well-marked classes: (1) merchandise notes, (2) notes discounted at banks, and (3) notes sold to the public. For our present purpose, we will group accounts payable, acceptances, and merchandise notes under the head of "trade credit." After considering this subject, we will take up bank credit and notes sold to the public. This is a convenient division of short-term borrowing which conforms to commercial practice.

Trade Credit

The fact that all the trade credit which a business normally utilizes is in fact a method of borrowing capital, seems to be overlooked; yet it is the chief source of capital in many concerns which do a trading business. There are literally tens of thousands of small merchants throughout the country who customarily buy nearly all their stock in trade on credit, and whose own capital is no more than sufficient to cover the purchase of store fixtures and perhaps some small advances on their first orders as a guarantee of their good faith. It is out of the question for them to pay their accounts with the wholesalers from whom they buy, until after they have sold the goods and thus have secured cash funds from their customers. Very often the wholesaler in his turn is "carried" to a great extent by the manufacturers and jobbers from whom he buys;

his proportion of owned capital, however, is likely to be much higher than the retailer's proportion. Going one step further back we reach the manufacturer with whom trade credit is comparatively a minor source of funds. Thus we have the whole process of selling goods through the ordinary trade channels financed to a considerable extent by the extension of credit. The ultimate customer is the only man in the chain who pays cash—and even the customer may in his turn be living on trade credit. As the customer pays for his purchases, the retailer is able to collect current funds which he transmits to the wholesaler, who in turn pays the manufacturer and jobber.

The extent to which trade credit is granted, depends chiefly upon the nature of the goods that are being retailed, and on the ability of the ultimate consumer to pay promptly. Sometimes extreme instances are found in which a whole community or a whole country is doing business largely on "trade credit." In Argentina, for example, during the several years preceding the beginning of the European War in 1914, all trade was handled on the basis of long credit. The importer of manufactured articles had become accustomed to receiving 90-day drafts (which is the usual term of drafts representing shipments from Europe or the United States to South American countries), and these drafts he was frequently able to renew for a like period; so that the importer was getting three months' to six months' credit on all his purchases. The importer in turn sold to country storekeepers on "open account" and was compelled to wait for his payment until the storekeeper could collect from his customers. The customers were for the most part land owners who had funds only at one season of the year, after the sale of their crops; consequently, the storekeeper was in the habit of securing three months' to nine months' terms for himself. Thus all business was being done on "long credit" and the proportion of owned capital

invested in retail, wholesale, and importing houses was abnormally small. By reason of the wonderful resources and prosperity of the country, this system worked fairly well for a number of years and made possible enormous profits in all lines of trade. Its danger was shown, however, when successive poor crops in 1912 and 1913 impaired the paying ability of the Argentine farmer and led to an enormous number of mercantile failures.*

Much the same situation and practices existed in the United States a generation or more back. Prior to the Civil War, purchases of merchandise were customarily settled by notes running six, eight, or ten months and sometimes longer. This was due to the fact that buyers came to market only once or twice a year, and then purchased their entire stock for the season, the buyers giving their notes which were readily indorsed and discounted. These were usually met out of the proceeds of the sale of the goods to the ultimate consumer. The Civil War upset this system. During the war and for some years after, merchandise business came down to a basis of cash or of credit of only ten to thirty days. When the next great expansion of trade took place in the early 80's, the increased confidence of sellers resulted in offering somewhat longer terms of credit, but these terms were combined with offers of liberal discount for cash payments, which is the custom in most lines today. The discounts were so attractive that retail merchants in good standing began to borrow from their local banks in order to take advantage of them. Thus the present practice of taking discount for cash was established; and prices are now made with that understanding. The high rates of discount are now in the nature of a penalty imposed on a merchant who takes the long terms which are nominally at his disposal. This change in custom of payment

*For a more detailed study of this situation see the author's report on "Financial Developments in South American Countries," issued by the Bureau of Foreign and Domestic Commerce, Washington, D. C.

was accompanied by the introduction of the commercial traveler, selling from sample in comparatively small lots. The process has been helped somewhat by the standardization of goods and selling methods, and the quicker turnover which has now become possible.*

For these reasons, trade credit in this country is relatively less important, and bank credit is more important, than was formerly the case. Another factor which should be mentioned as contributing powerfully to this result is the decentralized banking system of the United States, which puts one or more local banks at the door of every merchant and makes it comparatively easy for him to secure and utilize bank credit.

The European system of financing merchandise purchases rests upon the use and discounting of accepted drafts which are in effect two-name promissory notes. The wholesaler draws a time draft upon the retailer which accompanies the shipment of goods. The retailer writes or stamps his acceptance on the draft across its face and returns it to the wholesaler who is then in position to discount it with his bank. This is a method of financing merchandise transactions which, from the banker's standpoint, has a number of advantages, the chief of which is that every accepted draft represents an actual transfer of goods, and the banker is not compelled to lend, therefore, merely on the strength of the general credit standing of his customer. An effort is now being made, under the guidance of the Federal Reserve Board, to introduce this system in the United States. Although the movement is of genuine importance, we need not for our purposes consider it further. It is closely similar to the custom which prevails in certain lines of business of giving notes in payment for purchases of merchandise.

Some of the principal lines in which note-giving is still

*See an excellent article entitled "Proposal to Dehumanize Trade," by E. D. Page in *New York Annalist*, March 16, 1914.

common are harvesting machines, plumbers' supplies, book printing and binding, and electric trolley supplies. In most other lines, however, goods are sold on open account and notes are asked for only when the sale is made to a weak concern. Sellers are often so anxious to dispose of their products, and it is consequently so easy for established firms that have a clean record behind them to secure whatever goods they require on terms of 30 to 90 days or even longer, that trade credit may almost insensibly become a real source of danger. It is a delicate instrument which requires to be handled with watchfulness. A little carelessness in failing to meet trade accounts on the day they fall due may be sufficient to give a concern the reputation of being "slow pay," and thus may damage not only its credit with the firms from which it buys, but also its credit with banks as well as its general business standing.

On the other hand, there is undoubtedly such a thing as being overzealous in paying up trade accounts. Not only is there an actual loss of capital to the extent of the difference between a normal amount of trade credit and the amount which the company secures, but there is also to be considered the fact that the habit of paying accounts ahead of time, once it has been formed, cannot be easily broken. The writer has in mind one concern which started in business with ample funds. The treasurer saw no reason why he should utilize the credit of the firm and paid all bills in cash as they were presented, even though he obtained no discount. A year or two later the expansion of the company's business reduced the available cash, and the treasurer began to take the full term of payment to which he was entitled. Immediately some of his creditors became suspicious as to the solvency of the company, and rumors spread about which were so serious that it was necessary to bring more cash into the concern and resume, for the time being at least, the prompt payment of

bills. Thereafter the company proceeded by slow degrees to utilize the full line of trade credit to which it was entitled. There is much truth in the remark that the only way to acquire credit is to make use of it.

Bank Credit

It has already been noted that it is customary in this country for merchandising firms to take advantage of cash discounts in paying for their purchases and to secure the funds with which to make immediate payments by borrowing from their own banks. This practice spread throughout the country beginning in the 80's, but it originated in New York several years before. Shortly after the crisis of 1873, the late president of the Importers and Traders National Bank in New York City, Mr. Buell, rapidly built up the business of his institution by showing his customers how, by borrowing from his bank on their own single-name paper, they could obtain cash prices or cash discounts and thus show a substantial profit on their interest and discount accounts for the year. The custom is now so firmly established that practically every business concern in good standing counts on establishing a line of credit with its bank which will enable it to borrow simply by drawing its own notes and depositing them with the bank.

A variation in this custom exists among large manufacturing and commercial corporations which often find it advantageous to turn over their own notes to brokers who for a small commission sell them to any bank that may happen to have idle funds available. The note brokers sell the paper of large concerns throughout the country. At the time of the failure of the Booth Fisheries Company some years ago, and at the time of the more recent failure of the H. B. Claffin Company and associated concerns, it was found that the notes of these companies were scattered among banks throughout the United States. The banker who buys a single-name note

from a broker, very often has no knowledge whatever of the financial affairs of the company which issues the note. He may have heard the name of the company frequently and he probably considers the note broker a good fellow in whose honesty and judgment he has confidence, and that is the extent of the actual information before him when he makes his purchase. This loose method of doing business has brought some protest and is likely to be improved in part during the next few years.

A few large concerns which sell their short-term notes in the open market on a large scale, headed by the International Paper Company, have instituted the custom of having all their notes registered by a trust company, just as bonds are registered. This has at least the advantage of making it easy to ascertain how many notes a company has outstanding at any one time, thus avoiding gross overissues. A second important improvement is to be made a feature of the Federal Reserve banking system. It is the intention to place a complete record of the note obligations of all important concerns in the hands of members of the system. This record will, of course, include references to any defaults of bills in payment. In the course of a few years it will become a highly valuable aid to bank examiners and to the Federal Reserve officers in checking up the credit standing of borrowing companies.

One accepted rule which should be observed by corporations that sell their notes through brokers, is that they should not at the same time be discounting any large quantity of notes with their own banks. If they are using both banks and note brokers, they have no quick method of raising funds open to them in an emergency. If they are using either their own banks alone or note brokers alone, then they can turn, if it should become necessary, to the method that has not previously been utilized.

The abuse of bank credit has long been a weak feature in

modern business life, and will not quickly be eliminated. It may arise in two ways: either by making a wrong application of the funds secured from the bank, or by obtaining the funds on the strength of false or questionable claims. There are three legitimate reasons for making bank loans: first, to finance a temporary shortage of funds; second, to increase the stock of salable goods on hand; third, to extend additional credit to customers. The first reason may be quite acceptable, but only under exceptional circumstances. A firm, for instance, may have suffered a loss by fire and have insurance payments shortly due, in anticipation of which it may properly borrow from its bank; or it may have funds shortly coming in from its stockholders or from other sources. Each case of this kind must be decided on its own merits. The second reason is the one that is customary and that is generally considered soundest. It is, of course, necessary for both the borrower and the bank to be reasonably certain that the goods being purchased are salable, so that there may be no question as to meeting the note out of the proceeds of the sale. The third reason is also concerned with the sale of goods, but this time from the standpoint of the seller. It is necessary here for both the borrower and the bank to make sure that the credit which is being extended to customers, is well placed and sound.

If the borrower, instead of using the funds he receives from the bank for one of the three purposes above mentioned, utilizes it in extending his plant in the purchase of non-salable goods, in general advertising, or puts it into any other property or expenditure that is not readily convertible into cash, he may properly be said to be abusing the trust of his banker. More than that, he is seriously jeopardizing his own financial safety. "What difference does it make to the banker whether I use his money in one way or another?" is the answer of some business men, "sooner or later he will get his money

back with interest, and that's all he needs to fret about." Yes, but the banker is not in the business of making long-term loans or loans that may be sound enough but cannot be paid back on the dot. The only safe banking is short-term banking, and he is absolutely right when he insists that his loans be used only in quick turns and not for permanent or uncertain investments.

The other abuse of bank credit is best illustrated by the great Claflin failure in New York in the summer of 1914. On account of the high standing of the Claflin firm for generations, and its unquestioned credit, it was permitted to discount many millions of dollars of paper issued by its subsidiary corporations. It was learned after the failure, that much of this paper did not represent actual commercial transactions. It was simply put out more or less at random when the firm needed money. The H. B. Claflin Company's contingent liabilities were never reported; in fact, no complete financial statements were given to bankers. In the absence of financial statements and of any definite form of assurance that single-name notes or notes issued by one subsidiary company to another subsidiary company in the same organization are representative of commercial transactions, there is really no method of telling whether a corporation is borrowing beyond the limits of safety or not.

As is pointed out more fully on page 124, most banks are now beginning to insist quite properly on receiving financial statements. A committee of the New York Clearing House has suggested that a form of promissory note be devised, the signature to which certifies that the document is the product of a commercial transaction. The suggestion has merit, and with the strong backing of important banks behind it, might eventually be adopted. In this connection it might be well to say a word as to "accommodation" indorsements of commercial paper. This practice, which was formerly so prevalent

among individuals, is gradually dying away. There have been many instances of indorsers having suffered heavy losses simply because they were weak enough, or good-natured enough, to lend their credit to their acquaintances. Sometimes a corporation is guilty of lending its name in the same way, and with even less excuse. In fact, an indorsement by a corporation for accommodation is probably illegal, and would not be held good in most jurisdictions. A corporation is organized to carry on a certain line of business, for which it is granted definite powers under its charter. It is probably not within the legal power of any corporation to assume the responsibility which goes with an indorsement given without consideration.

Bank Collateral

We have spoken in the preceding section of bank credit as if it were always obtained on the strength of a firm's general standing. This is, in fact, the case when a concern borrows simply by giving its unsecured note, and even when it indorses and discounts a note which it has received from some customer who is practically unknown to the bank. Bank credit is even more extensively obtained, however, when it is directly backed by collateral security of some kind. Such loans are more easily granted, not only because the banker calculates that he is secured against loss, but also because he has a better check on the uses to which his money is to be put.

Collateral may be conveniently classified under three heads:

Stocks and Bonds

Merchandise

Bills and Accounts Receivable

The first of these three classes is the banker's favorite, at least in the United States. This is due to the fact that stocks and bonds are usually salable, so that in case of default on the

part of the borrower, the banker should have little difficulty in disposing of the collateral and repaying most or all of his advances. This statement is not to be taken as applying indiscriminately, to be sure, to all stocks and bonds; for the securities of some local or little known companies, even though the companies may be carrying on a successful business, are about as unmarketable property as can be mentioned. At the other extreme are the active securities of the great corporations which are being daily bought and sold in large quantities on the New York and other stock exchanges; these are the securities that serve as collateral for the enormous amounts of call loans kept outstanding by the banks of the New York financial district. Between the two extremes there are many sound securities which the banker regards as at least fairly marketable, and which he is willing to take as collateral. Some of these securities are owned by commercial and manufacturing corporations which may properly use them as a basis for bank credit. There is, however, a limitation to be noted here. It is not regarded as sound practice for a corporation to post as collateral the stock of a subsidiary company. In the first place, the stock probably has no active market and the bank will accept it only reluctantly and when it is mixed with some salable collateral, and, in the second place, the corporation should not be compelled to take any chances—even remote chances—of losing control of an essential piece of property. The securities of subsidiary companies may serve properly as collateral for long-term bond issues, but not as collateral for bank loans.

Merchandise serves as collateral when a company posts warehouse receipts, bills of lading, or specific liens upon specific pieces of its personal property as collateral. The first-named case is the one that is most common. Millions of dollars of holdings of cotton, wheat, and other grains are carried in this way every year following the harvesting of the crops.

Once in a while manufacturing corporations may have collateral of this nature, as when a steel manufacturing company holds pig iron, but this is unusual. Bills of lading indorsed to the order of the bank commonly serve as collateral for drafts discounted by the seller of merchandise. Millions of dollars worth of grain, live stock, and other goods in transit are in this way utilized as backing for loans made by the banks, and accepted as collateral up to a fair proportion of their face value for direct bank loans. This is particularly true in the export trade where the banker does not feel sure enough of the standing of the drawer of the draft or of the salability of the merchandise to risk discounting the whole draft, but is willing to make advances up to, say, 50, 60, 80% or more of its face value. This is true also when the merchandise consists of goods that are perishable or that do not have a ready market. A draft covering a shipment of fruit, for instance, might not be readily discounted, but several of these drafts would be regarded as good collateral for an advance of say 50 to 75% against their face value. Liens on specific pieces of personal property are not common, but may at times be perfectly good banking collateral.

Accounts receivable fall into a different class. The evidence of indebtedness of a third party to the borrower is so uncertain and the claims upon specific property are so indirect, that accounts receivable are not customarily accepted as sound collateral for a bank loan. It is considered better for the company to borrow on its general credit rather than to assign its accounts receivable as collateral. Yet this customary rule appears to be based nearly as much upon prejudice as upon careful investigation. As a result of the unwillingness of most banks to accept assignments of accounts receivable as collateral, a considerable number of financing and discount houses have come into prominence during the last few years. These houses make a specialty of advancing money against open ac-

counts. It will be more convenient to discuss their methods and activities at some length a little later when we come to consider working capital. For the present, it is enough to note that during the sudden and severe crises produced in the United States in the fall of 1914 by the outbreak of the European War, the influence of these discount houses was perceptibly increased. They customarily charge an interest of 6%, plus a commission of 1 or 2%. They ordinarily allow interest to the customer on all items as fast as collected, and, inasmuch as they carry no deposits, they do not follow the banking custom of requiring that 20 to 25% of the proceeds of a loan remain on deposit without interest. They usually make advances up to about 80 to 85% of the face value of the receivables that have been assigned. The example of these discount houses has recently been followed, within moderate limitations, by some of the more progressive mercantile banks. The old prejudice against "hocking" accounts appears to be fading away.

Factors Considered by Banks in Making Loans

The underlying principles followed by the banker in extending credit have been touched upon in the two preceding sections. It is important to bear in mind particularly, first, that the commercial banker must confine himself to making short-term loans; second, that he should satisfy himself that the money he loans is to be invested in such a way that it can readily be reconverted into cash; third, that credit granted on the general standing of a business enterprise entitles the banker to full and detailed knowledge of the inside workings of the enterprise; fourth, that collateral, to be acceptable, should consist either of securities and merchandise which are readily salable, or of drafts and accounts receivable which are quickly convertible into cash.

Supplementing these four basic principles, there are some

observations to be made at this point as to factors which are taken into consideration by banks in making loans. First of all, attention should be directed to the growing custom of requiring detailed financial statements of customers to be filed from time to time. There was a time in this country not many years ago when a bank's request for such a statement was looked upon by the customer as in the nature of an affront or an impertinence. This is even yet the case in some sections of the United States, and is notably true in South America. However, this feeling is rapidly giving way to the saner idea that a bank is certainly entitled to reasonably accurate and full information as to any concern to which it is lending money, and that it is to the interest of conservative borrowers to comply with the bank's request for statements and thus put itself in a different class from non-conservative borrowers who are inclined to be secretive. The banks themselves are more and more inclined to insist not only on complete statements, but also on statements certified by public accountants. Such a suggestion is not intended as a reflection on the honesty or capability of the corporation's own accounting force; it simply brings to bear in addition the judgment of an unbiased person of wide experience who is in a far better position to value assets than any officer or employee of the corporation.

That banks are in favor of certified statements is plain from the answers received to a circular letter sent out in March, 1914, by the American Association of Public Accountants, asking for bankers' opinions on this point. The 844 replies were distributed as follows:

Strongly in favor.....	121
Favorable	501
Opposed	15
Strongly opposed.....	5
Non-committal	202

Among the factors considered by banks in making loans, must necessarily be the legal restrictions in force or likely soon to be in force. The banking law which went into effect in 1914 provides that, "any Federal Reserve Bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions." The effect of this law is to increase the value of two-name paper, accepted drafts, and other evidences of debt, which are the direct results of commercial transactions, and correspondingly to decrease somewhat the value of paper which is not available for rediscounting at Federal Reserve Banks. Under this law, the paper issued by one subsidiary company to a holding company as an accommodation note—such as the 30 to 40 million dollars of Claflin notes previously referred to—would not be available for rediscounting. One result of the collapse of the Claflin firm was to strengthen greatly the movement in favor of putting a premium upon paper which arises out of commercial transactions.

The Federal Reserve system also favors the policy of getting more written information than has heretofore been required from customers in making applications for loans. Not only will paper based upon certified financial statements be favored in the rediscounting operations of the Federal Reserve Bank, but also there will probably be a strong tendency to insist that some evidence be given that bank loans are "self-liquidating" and that some assurance be extended that the loans are not to be used for permanent improvements to plants and the like.

Among the unwritten rules that have long been customary among bankers in making loans, these two are of chief importance: First, at least 20% of the bank loans should be retained as a deposit in the bank, the other 80% only being available for meeting obligations. This is a long standing custom, but is not universal. It is more strictly applied by

some banks and in some lines of business than in others. Second, all bank loans should be "cleaned up" at least once a year so that the bank may make sure that the money it lends is not going into permanent investments. This is especially necessary in those lines of business which have well marked seasons of activity. It would be clearly inadvisable for a bank to allow a customer in such a line credit for the coming season until after he has paid up his loans for the previous season. With manufacturing corporations the rule is not so strictly applied; yet, even here it is properly thought to be desirable that the company's balance sheet should once in a while be wiped clear of bank loans. If this cannot be done, it is clear enough evidence that the company is using bank funds as a part of its permanent capital, and that it should be reinforced by the sale of more stock or long-term securities.

All these rules of successful and conservative banking are also the rules of successful and conservative financing of all business corporations which borrow from banks. There is no conflict whatever between the two points of view. A banker wishes in normal times to lend as much as he can safely place; the treasurer of a borrowing corporation wishes to borrow as much as is consistent with safety. In theory there should never be a disagreement or a hitch between them. However, the frailties of human nature are not so easily set aside. A treasurer's prejudices and fancied interests frequently lead him to oppose reasonable requests and criticisms; on the other hand, a banker is at least equally liable to suffer from obstinate prejudices. Recently an eastern manufacturer asked his banker for a loan of \$25,000. "I see," said the banker looking over the manufacturer's statement, "that your advertising expense for last year just about equals \$25,000. If you would cut off your advertising you would have all the money you need." The manufacturer tried to explain that it was necessary for him to advertise in order to sell his goods,

and that the money borrowed from his bank was required in order to purchase raw materials which would be quickly manufactured into salable articles. But the banker had a prejudice against advertising which nothing could shake.* The banker's work has a tendency to make him a slave to routine and to fixed ideas, which are obstacles to the prosperity both of his customers and of himself.

Short-Term Notes Sold to the Public

The exact line of division between notes delivered to note brokers and by them sold to banks, and notes delivered to private banking houses and sold to the general public may seem somewhat hazy. As a matter of fact, however, there is usually little difficulty in classifying a note as belonging in one or the other of these two groups. A note intended for sale to bankers is seldom more than 90 days and never more than six months, in length. A note intended for wider distribution is customarily from one year to five years in length. As just indicated, the note brokers who handle the sale of the first class are entirely different from the stock and bond brokers and private banking firms that handle notes of the second class.

Short-term notes for sale to the public may be legitimately issued for one of two purposes: either in anticipation of a later issue of long-term bonds or other securities, or in order to finance purchases or an improvement which is expected to produce so much new revenue that the note issue can be paid off at maturity out of the corporation's income.

In order to facilitate the repayment, notes running for three to five years or longer are frequently issued in series; that is to say, an equal proportion of the note issue matures each year. They are in denominations ordinarily of \$1,000,

*See article on "Advertising as a Bankable Asset," by Edward Mott Woolley, in *Printer's Ink*, October 15, 1914.

although they are sometimes as low as \$500 or even \$100, and they frequently go up to \$10,000 or even \$100,000.

Short-term notes have been a feature of practically every financial crisis since the Civil War with the exception of 1884. This has been due to the desire of established corporations to avoid refunding of long-term bond issues which fall due during a crisis. This is certainly legitimate enough within proper limitations. In recent years, however, the habit of putting out note issues has grown even among the conservative companies to such an extent that it is regarded as a real source of danger.

Note issues have been utilized of late for almost every conceivable purpose for which long-time bonds used formerly to be emitted; for financing consolidations, to procure cash in connection with liquidations, to effect segregation of corporations. Approximately \$130,000,000 in short-term notes were issued in Wall Street in 1903-1904 in connection with the "rich men's" panic of that winter. In 1907 they aggregated about \$300,000,000; in 1912, approximately \$500,000,000; and over \$550,000,000 fell due in 1914.*

Until recently, short-term note issues have been almost universally successful. The railroad notes have generally been refunded on maturity by bond issues. Their danger, however, is shown by the experience of the Erie Railroad Company in 1908. This company had put out one-year notes in the middle of the crisis of 1907, which matured April 8, 1908. Four days before maturity J. P. Morgan and Company, as the railroad's financial agents, published a notice to the effect that the notes would be refunded provided they were all deposited on or before April 8. As some of the notes were in Europe, compliance with this request was impossible. The 8th of April came. Some European notes were presented for payment and

*See article on "A Rickety Practice in Finance," by William Z. Ripley, in *New York Annalist*, April 6, 1914.

it was announced that the money for their redemption was not at hand. To all appearances another bankruptcy was impending. Then suddenly E. H. Harriman, from his sick-bed, telephoned that he would take the whole burden upon himself. Immediately he arranged for a refunding issue of three-year notes and brought about a satisfactory redemption of the previous issue. It was one of the most dramatic incidents in the history of American finance. The occurrence serves to illustrate clearly the dangers that beset every corporation that relies too much on short-term notes which it cannot possibly hope to meet except by issuing other securities. As was remarked by Guy E. Tripp, chairman of the Westinghouse Electric Manufacturing Company in 1914, "It is a bad thing to have a debt that you never intend to pay and never can pay; and that is what some short-term notes are."

Aside from the danger, excessive financing through short-term notes is apt to become expensive. The interest payments may not be high, but every issue must be underwritten, and the underwriting commissions in a few years become a heavy burden.

The highest grade short-term notes of large railroad and industrial corporations, ordinarily sell on a basis of 4% to 5½%. A specialist in these notes said recently that he regarded those yielding over 7% as the rankest kind of speculation, and "much more dangerous than active stocks which can generally be sold within one point of previous sales. A loss on a note when it comes, is like a fire loss; it is generally total."

At the present writing, some securities of this type are being quoted to yield as high as 10, 12 and 15%. Some buyers of these high-yield notes have made a great deal of money on them, but they are to be regarded as dangerous in the extreme for any one who is not intimately acquainted with the issuing company.

As the notes approach within six months or less of maturity, they come into an entirely different class, for they become available for the use of banks. Hence, they sell at prices which make their yield approximate the yield of commercial paper of the highest class. Sometimes the yield may be as low as $1\frac{1}{2}$ or 2%.

A curious situation arises as a note comes very close to maturity, due to the fact that fluctuations of as little as even $1/8$ or $1/16$ in the purchase price may make a considerable difference in the yield; consequently, the tendency is for such notes nearing maturity to keep out of the market.

Some short-term notes are secured by collateral; others, as in the case of the Pennsylvania Railroad, rest solely upon the credit and reputation of the issuing company. Curiously enough, notes which command the best price and have the broadest market have no collateral behind them. The fact that collateral is posted is looked upon as indicating that the company has already used up all its unsecured credit.

Professor Ripley has forced direct attention to what he well calls "the most deceptive practice" of carrying short-term notes in corporation balance sheets as a portion of funded debt instead of including them among the current liabilities. This has been true even of corporations of the standing of the Erie Railroad, and the Baltimore and Ohio Railroad. Notes running as long as 4 or 5 years are not, it is true, in exactly the same class as bank loans and accounts payable, most of which fall due within 30 to 90 days, but they are by no means a funded obligation. They must be met either out of income or by the issuance of long-term loans. They are properly offset and secured, as we shall see a little later, not by the permanent property and investments of the issuing corporations, but by the assets which are readily convertible into cash.

CHAPTER VII

BORROWED CAPITAL—LONG-TERM

Bonds and Mortgages

There is a fundamental difference—as will be emphasized from time to time in this volume—between short-term borrowing and long-term borrowing. While they tend in certain isolated cases to merge into each other, the distinction, as has already been pointed out, is for practical purposes clearly marked.

The simplest form of long-term or “funded” borrowing is the ordinary mortgage on real estate or, as it is more correctly called, the bond and mortgage. The form of this instrument is almost as ancient as law itself. It purports to be a transfer of the title to a piece of real estate from the former owner to a new owner, with the proviso, however, that the title may be redeemed by the former owner by his repayment, at maturity, of an acknowledged debt which he obligates or “bonds” himself to repay. Although this is the immemorial form, the instrument does not, as a matter of practice and of legal interpretation, actually convey ownership of the property cited; its effect, in spite of the wording of the mortgage, is merely to pledge the property as security for the repayment of the loan. There are varying forms of the bond and mortgage in the different states which may not be covered in all their details by the description given above, but the essential characteristics of these bonds and mortgages are the same in all cases.

The bond and mortgage is used ordinarily for relatively small amounts. It is the favorite form under which individuals who own farms, city real estate, and other property,

raise long-term loans secured by this property. It is frequently used also by smaller partnerships and corporations. But there are, of course, some obvious drawbacks to this form. In the first place, it is necessary for the mortgagor to find some one who is willing to invest the whole amount named in the bond in a lump sum. This may not be difficult so long as the sum is small. Mortgages are very commonly taken by savings banks and other institutions as well as by individuals who reside in the neighborhood of the property mortgaged and therefore are acquainted with it and at the same time are able and willing to advance the sum of money that is required. Within recent years there has been a concerted and successful effort to extend the market for farm mortgages, and a number of brokers operating in the agricultural states west of the Mississippi have built up successful businesses in selling mortgages direct to investors in the eastern states. Nevertheless the limitations make this a relatively inefficient and uneconomical method of raising funds.*

The mortgagor of a piece of property may wish to borrow, let us say, \$20,000. He finds three men, one of whom could lend \$10,000, one \$8,000, and the third, \$2,000, but no one who is in position to lend \$20,000. All insist on being protected by a first mortgage. How is the difficulty to be solved? The answer is to be found in separating the bond and the mortgage. Let the mortgage be drawn in favor of some disinterested party who will hold it, as trustee, for the lenders of the money. Let a bond, or promise to repay the sum advanced, be given to each lender, the bond to be secured by the claim on the property which has been given to the trustee. By separating the bond and mortgage we have made it pos-

*In most other countries where agriculture is highly developed there are "mortgage banks" which make it their business to receive and hold in trust mortgages of farm land and to issue their own bonds based upon these mortgages. It is thus possible to secure for farmers the same advantages that are treated in the next paragraph and that are now secured in the United States almost solely by large corporations.

sible to secure the money that is needed from any number of different sources and yet have given the same protection to each lender that would be obtained by an individual who might advance the whole sum in a lump.

Several years ago, for example, John Wanamaker, who was at that time individually the owner of his Philadelphia store, wished to borrow \$10,000,000. It would have been a difficult thing to find one man or one institution that was willing to lend \$10,000,000, but it was not especially difficult to give one mortgage for this sum, to issue 10,000 bonds each for \$1,000, all equally secured by the mortgage, and to sell the bonds to investors. It is in this manner that the mortgage bond issues of corporations are created.

Corporate Deeds of Trust

The mortgage, separated from the bond, is more commonly known as a "deed of trust." In ordinary practice, the trustee who holds title to the property mortgaged and is supposed to act on behalf of the bondholders is a trust company. Ordinarily, the trust company, however, is actually chosen, not by the bondholders, but by the corporation which issues the bonds. It is always expected at the outset that its duties will be of a purely formal character, and in the comparatively rare instances where it has been necessary for the trustee to take some active steps in order to protect the interests of the bondholders, there has been considerable complaint that its duties as a trustee were not performed with sufficient vigor. It would seem that some effective remedy for this complaint ought, if possible, to be found. The investment bankers of the country who have a moral responsibility in the matter, in that they sell corporate bonds in large quantities to the general public, might well consider the advisability of using their powerful influence to insure closer vigilance on the part of the trustees of large corporate mortgages.

The deed of trust for important bond issues is apt to be an extremely complicated and detailed document. To the lay reader its phrasing—like the phrasing of many other legal documents—appears cumbersome and unnecessarily redundant; but it must be borne in mind that thousands of cases have been adjudicated, each one of which has helped to interpret the exact shade of meaning of certain combinations of words. After the interpretation has once been made, it is safer by far to use that combination of words in the future, rather than to introduce new difficulties. As the result of long experience, corporate deeds of trust now tend to follow customary models and usually contain practically the following information:

1. A preamble which sets forth the legal status of the corporation; the amount of the bond issue and also of its other bond issues; the authority given by the stockholders and directors for granting the mortgage; the full text of the bond and other similar information.
2. The granting clause which transfers the property to the trustee; describes the duties of the trustee; and contains the covenant of the corporation to pay principal and interest on the bond issue as due.
3. The obligation of the corporation to maintain the property in good condition; to keep it insured; to pay taxes and the like.
4. The procedure of the trustee in case of default. Usually there is no technical default until 30 days or more after a payment has become due. The percentage of bondholders—usually 20 to 25%—at whose request the trustee shall proceed to foreclose the mortgage or to take such steps as may be prescribed.

5. The responsibilities, liabilities, and compensation of the trustee are presented, and provision is made for the resignation or removal of a trustee, and for the appointment of a successor.

Many corporate mortgages contain what is known as the "after acquired property" clause, which makes the mortgage cover not only the specific pieces of property described therein, but also such other property as may later be acquired. The object clearly is to furnish further protection to the bondholders and to make it difficult for the corporation to embark upon new expenditures without giving full protection to the bondholders. When this clause is missing, there is always the possible danger that the property covered by the mortgage may deteriorate or at least become of secondary importance as compared with other property later acquired. Suppose, for instance, that a manufacturing corporation mortgages one of its plants but later purchases another plant which is better located; in that case the first plant would probably be neglected and would rapidly deteriorate.

There is the opposite danger to the corporation in case the "after acquired property" clause is included in the mortgage. The company may later wish to purchase property essential to its business and which will tend to increase the value of the property mortgaged. In order to purchase the new property, it will need to borrow more funds. But the "after acquired property" clause covers the new property with a first lien so that it may be impracticable to use it as security for the new loan. The usual solution of this particular problem seems to be to evade the provisions of the mortgage by turning over the newly acquired property to a subsidiary corporation which is then able to give a first mortgage and go ahead with whatever borrowing is required.

The question as to whether to include the "after acquired

property" clause or not, is clearly a choice between evils. There is no universal answer. The circumstances and probabilities in each case must be considered. This is a problem that would be more easily solved if the trustees of corporate mortgages were willing to assume a greater responsibility, in which case the bondholders would doubtless be willing to leave them a considerable amount of discretion.

Another question in connection with most corporate mortgages and bond issues, is whether they shall be "closed" or "open." They are "closed" when a given amount of bonds is at once issued under the mortgage, but no more may later be issued. The "open" mortgage, which is not customary except with railroad companies, leaves the total amount indefinite, although some restrictions are imposed. The most common arrangement is to permit the issue of bonds at a fixed rate per mile of track. The "closed" mortgage, like the "after acquired property" clause, may prove a serious hindrance to the financing of new purchases which may be in every respect desirable. The "open" mortgage is subject to obvious abuses. In the practice of railroad corporations, a compromise has been found in recent years through the creation of what is known as "limited open end" mortgages, which authorize the ultimate issue of a much larger amount of bonds than it is intended to issue immediately. In this way, the future is provided for to a reasonable extent and yet the bondholders are protected from a reckless overissue which would dangerously reduce the margin of safety back of their holdings.

These "limited open end" mortgages may even cover bonds all of one issue but bearing different rates of interest. This has been the case with a number of railroad mortgage issues. Both the Chicago and Northwestern Railroad, and the Chicago, Milwaukee and St. Paul Railroad, have general mortgages protecting some bonds that bear $3\frac{1}{2}\%$ and others that bear 4% interest.

Corporate Bonds

The larger an issue of corporate bonds—assuming of course that it is well secured—the greater will be the marketability, and consequently the value of each bond. It is clear that a local corporation which puts out, let us say, one hundred \$1,000 bonds, will be able to sell them only in its local market. The issue is too small either to become well known or to be easily salable at a moment's notice. The big bond issues, on the other hand, are being traded in all the time. It is for this reason that the tendency has been strong in the United States toward consolidating the various bond issues of the larger corporations into one issue, under a so-called "blanket" mortgage, thus securing the important advantages of simplicity and of ready salability. \$100,000,000 bond issues, which a few years ago were rare, are no longer regarded as uncommon. There are a number of much larger issues, the biggest of all being the recently authorized issue, amounting to \$750,000,000, of the Northern Pacific Railroad Company.

In England this tendency toward large single issues is not nearly so apparent. On the contrary, English practice seems strongly to favor "hand to mouth" financing. Whenever money is needed, a separate security is planned and issued without much reference either to previous security issues or to the future. The result is that many of the English companies have a complex series of small bond issues, the relative claims and value of which can be determined only after competent study. The basic reason is doubtless to be found in the fact that the English investing public is more accustomed to buying and holding securities until their maturity so that there is relatively less trading in the open market than in this country.

The great majority of bonds in the United States are in denomination of \$1,000, although \$500 is not uncommon. In recent years there has been a widely advertised tendency

toward the so-called "baby" bonds of \$100 denomination. The chief argument for these bonds is that they make it possible for a small investor, with perhaps only \$1,000 to \$5,000 available, to diversify his investment just as is commonly done by large investors. This is an important benefit where its effect obviously is to reduce considerably the risk of heavy loss. The disadvantage lies in the increased cost of selling. It costs practically as much for a banker to sell a \$100 bond as to sell a \$1,000 bond, and his clerical expenses in connection with the transaction are fully as great. Unless he is operating on a larger margin of profit he does not find the small bond business very attractive.

Bonds are frequently expressed in a currency different from that of the country in which they are issued. There are a great many Canadian bonds, for example, that are payable in pounds sterling, with a view to facilitating their sale in the London market. The Pennsylvania Railroad Company, the New York Central and Hudson River Railroad Company, and others, have issues that are payable in francs as well as in sterling. The Brazil Railways Company, an American corporation operating in South America, has a curious medley of issues payable in milreis (Brazilian currency), francs, pounds sterling, and dollars. Before the European War, a stronger and stronger tendency had been evident toward making the larger and more important issues international, and providing for their payment at fixed rates of exchange in the currency of any of the larger commercial countries, at the option of the holder. It is clear that this tendency has been checked.

A great many bonds, especially those of an international character, are specifically payable in gold coin. This is a highly important provision in the countries in which there is fluctuation, or any considerable danger of fluctuation, in the value of the national currency. The European War, for in-

stance, caused a sudden drop in the value of the currencies of Brazil, Chile, and other South American countries, which inflicted serious loss on many holders of securities payable in national currency. On the other hand, corporations suffered serious loss if they were unable to increase their receipts in national currency but at the same time had to pay their obligations in gold. This was one direct cause of the bankruptcy of some large enterprises. During the period of free silver agitation in the United States, prior to 1896, bonds which included the so-called "gold" clause, sold at a considerably better rate than those which were payable in American currency, the value of which it was feared might depreciate.

The life of bond issues naturally varies a great deal, depending upon the prominence of the business and the nature of the assets offered as security. We shall have occasion to discuss this question with more detail in connection with the subject of methods of redemption of bonds. Some issues are perpetual. Among railroads, 100-year bonds have been fairly popular issues. Among those now outstanding which were put out for this period, are Lake Shore and Michigan first 3½'s, issued in 1897; Norfolk and Western first consolidated 4's, issued in 1896; Union Pacific, first and refunding 4's, issued in 1908; Manhattan Railway Elevated 4's, issued in 1890; and Reading divisional mortgage issue of 1897. The Northern Pacific has one mortgage for 101 and another for 150 years; the Erie Railroad has two mortgages at 91 years and one at 84 years.

Interest is almost always paid semiannually. The favorite dates are probably January and July, although payments are scattered through the year. On account of the tendency which exists toward reinvesting interest and dividend disbursements in January and June, and the consequent tendency to increase stock-market prices at this time, there is theoretically a slight

advantage to the bondholder in getting his interest payments at other periods. This can hardly be called a consideration of much practical weight.

We have already noted in speaking of stock certificates that bond certificates may be either in registered or coupon form. In American practice some bond issues are registered and some are in "bearer" or coupon form. It is becoming more and more the custom with large issues to give the owners of bonds a choice between the two forms. The registered form has the advantage of greater safety and the bearer form the advantage of greater convenience. When the issuing corporation is located at considerable distance or an international market is desired, the bearer form is likely to be preferred. The favorite plan at the present time is to make bonds registered as to principal so that the transfer of the bond is not fully completed until it is made on the books of the corporation, but to attach coupons covering the interest payments so that coupons—which are practically post-dated checks—may be clipped and deposited as they fall due. This has been demonstrated by long experience to be the simplest and most satisfactory method of collecting interest payments.

It has been assumed so far in this chapter that bonds are always secured by mortgages covering real property. This is not, however, the case. There are three other important types of security: first, bonds, shares, or other securities may be posted as collateral; second, a lien on chattel property such as locomotives, rolling stock, and the like may be accepted as security; third, the general credit of a corporation may be the only security.

We shall see plainly, in reviewing these various types of securities and their variations, that it is unsafe to place much dependence upon names. A "general mortgage" may not have a first lien upon anything; "first and refunding" or "first and unifying" and the like may indicate a first mortgage on some

small subdivisions of the property and a second, third, or fourth mortgage on the rest of the property. Every bond issue stands by itself and has its own peculiarities. It is unsafe to comment upon it—and it is certainly unsafe in the extreme to buy it—without having first studied with some care the exact terms and extent of its claim upon property and the nature and value of the property itself.

Mortgage Bonds

Bonds that are backed by a mortgage on real property are, in this country, the most popular type of bonds and will probably always remain so. In the United Kingdom it is customary to issue debenture bonds (having no specific security behind them) in many cases where we issue mortgage bonds. The difference is in name rather than in fact, for the English debenture bonds are considered by the investor with at least partial reference to the amount and the nature of the corporation's holdings of real property.

After all, the great bulk of the wealth of this country is in the form of real estate. The greater the increase of other forms of wealth, the greater must be, necessarily, the increase in land values. Hence, a mortgage on land, assuming that it is conservatively placed, is bound to remain the most common and perhaps the safest form of security. This is not to say, by any means, that every mortgage bond is safe, but only to state the general principle that land and other real property constitute the most acceptable form of security for bond issues.

Not only is a promise to pay secured by real estate the most popular type of secured obligation, but, for most individually owned businesses, partnerships, and small corporations, it is in fact the only practical form of long-term obligation. Other forms of security are utilized in the main only by large concerns which are widely and favorably known and

therefore enjoy an exceptional measure of credit apart from their property holdings.

The great mass of obligations on real property are secured by first mortgages. There is a considerable amount, also, of second mortgage securities and relatively few third and fourth mortgage securities. Third and fourth mortgages are seldom found except among the obligations of large railroad corporations. The Northern Pacific put out a third mortgage issue of \$12,000,000 in 1887; the Erie Railroad has outstanding third, fourth, and fifth mortgage bonds. Modern practice favors disguising these junior issues by some euphemistic and suggestive title. For instance, in the financing of the Erie Railroad when a sixth mortgage issue was found to be necessary, it was not called a "sixth mortgage" but "Erie Railroad First Consolidated Mortgage 7's, 1920." This title does not mean, as the unsophisticated might imagine, that the issue is protected by a first mortgage, but only by a "first consolidated mortgage" whatever that may be. A little later we have the "First Consolidated 4's, 1996," which receive the title of "first" apparently because, though not the first consolidated issue of the road, they are the first consolidated issue to bear interest at the rate of 4%. Finally, the Erie put out what is practically an eighth mortgage, which was christened "General Mortgage Convertible 4's, 1953."*

The Erie is a shining, but by no means isolated, example. It would not be difficult to bring to light many another fourth, fifth, sixth, or even later mortgage which is masquerading as a "first refunding" or "prior lien" or under some other high-sounding name.

A second mortgage issue, when it is recognized as such, will customarily have to pay a rate of interest $\frac{1}{2}$ to 1% higher than a first mortgage issue, and will customarily, also, be redeemable within a shorter period. The issues which are

*See W. H. Lyon's "Capitalization," pp. 118-121.

protected by subsequent mortgages may be expected ordinarily to pay still higher interest rates in rough proportion to the priority of their claims. However, this is not stated as an invariable rule, for in many cases the junior mortgage issues are of larger size and enjoy a wider market or have the other advantages which more than compensate for the inferiority of their liens.

Ratio of Mortgage to Value

The question as to the correct percentage of obligations secured by mortgage to the appraised value of the mortgaged property is one of much practical interest. There are many surprising variations in practice. Roughly speaking, it may be said that the highest grade issues, secured by a mortgage on land, do not exceed 50 to 60% of the appraised value of the land. The highly regarded "cedulas," for example, issued by the National Mortgage Bank of the Argentine Republic, never exceed 50% of the appraised value of the mortgaged land. In ordinary practice, a second mortgage on land should not bring the total mortgage issues above 80% of its value. A mortgage based in part on buildings and other improvements which may not be easily adapted to other uses, and are not so readily salable as land alone, cannot safely run to as high a percentage of the appraised value.

The percentages that have just been given are intended to represent an ideal—or at any rate, the most exacting standards—rather than ordinary commercial practice. The following examples picked at random from the reports of many different companies operating in various fields and carrying on various kinds of business, show provisions that have been found acceptable by some of the good banking houses:

The Montreal Light, Heat and Power Company has permission to issue $4\frac{1}{2}\%$ first mortgage bonds, to pay for improvement up to 75% of the cost of the improvements.

The Mississippi River Power Company can issue bonds in excess of \$16,000,000 under its first mortgage, up to 80% of the cost of improvements.

The Powell River Company, which produces water-power, manufactures paper, etc., can issue additional bonds under its first mortgage up to not more than 50% of the actual cost of permanent extensions, additions, improvements, or acquisitions.

The Steel Company of Canada, Ltd., may issue additional bonds to the extent of 66 $\frac{2}{3}$ % of the proposed value of new fixed assets.

The Taylor-Wharton Iron and Steel Company may issue its first mortgage 5's beyond \$1,250,000 for permanent improvements up to 75% of their cost.

The American Ice Company may issue the balance of its real estate first and general sinking fund gold 6's, for improvements up to 75% of the cost.

The United States Lumber and Cotton Company can issue additional bonds to the extent of 50% of the cost of betterments.

The American Sales Book Company, Ltd., may put out the balance of its first sinking fund 6's, up to 80% of the cost of extensions.

Both the New York and Cuba Mail Steamship Company and the New York and Porto Rico Steamship Company are permitted to issue additional first 5's for 80% of the actual cost of new property.

The General Baking Company, incorporated in 1911, a combination of twenty large baking establishments in various large eastern cities, is permitted to issue the balance of its authorized first mortgage bonds to the extent of 70% of the cost of permanent betterments, improvements, developments, extensions, and additions, except for the purchase of stocks of other companies.

The General Pipe Line Company may issue bonds to provide 80% of the actual cost of acquisitions, additions, etc.

The International Milling Company of Minnesota may issue bonds up to 75% of the actual cost of the establishment of additional mills.

The Iroquois Iron Company may issue first gold 5's up to 60% of the cost of additions and extensions.

The Chicago Bell Telephone Company restricts its first mortgage issue to 50% of the value of its property or 60% of the value of its real estate; it may issue further bonds not to exceed 75% of the cost of additional improvements and extensions.

The Nashville Railway and Light Company may issue its authorized bonds up to 80% of the cost of improvements.

In general, manufacturing companies are supposed to preserve a margin of safety of at least 25% between the cost of improvements and the amount of bonds issued to finance these improvements. This margin may be reduced to 20% in the case of companies that have a very stable business, or may be increased to as much as 40 or 50% for companies that do not claim any especial degree of stability in their earnings.

Equipment Trust Bonds

When a dealer sells a piano on the instalment plan, he does not ordinarily give his customer at once full title to the piano; instead he "leases" it at a rental equal to the amount of the instalment payments agreed upon, with a further agreement that as soon as the payments under the lease equal the agreed price for the piano, then these payments shall cease and full title shall pass to the customer. By this simple device he protects himself in part against an unscrupulous purchaser who might, if he had full title, dispose of the piano, spend the cash that he received in payment, and leave the dealer only the doubtful privilege of suing him for fulfilment of his con-

tract. Under the "lease" arrangement, the customer has no right to resell the piano until his own payments have been fully completed. It is, of course, recognized that a "lease" of this kind is essentially a legal fiction—just as the mortgage which conveys the title to the lender of money is a legal fiction. Nevertheless it is a fiction which is useful and indeed indispensable.

When a manufacturer of railroad equipment sells an order of millions of dollars' worth of cars or locomotives to a railroad, he protects himself in the same way. The title is retained in his own hands; the railroad merely "leases" the rolling stock with an agreement that on completion of the payment of a certain amount, the "lease" shall become inoperative and the title will be taken by the railroad. Thus the railroad company—just like the individual who buys his piano on the instalment plan—is unable to dispose of the cars. A point of greater practical importance is that, in case of receivership or financial embarrassment, the seller of the cars or locomotives can take them back if he chooses; they belong to him, not to the railroad.

There are some variations of this procedure but they do not affect its principle. The chief variation consists in the introduction of a financing company between the manufacturer of railroad equipment and the railroad company which purchases the equipment. The financing company takes upon itself the burden of paying the manufacturer, and receives title to the cars or locomotives. This title it may offer as security for an issue of equipment trust obligations in the form of bonds or notes.*

Equipment bonds enjoy an excellent reputation for safety; in fact, it is claimed that there has been no default on them since they have been in use. Even though a railroad may go

*These equipment trust obligations may be called either bonds or notes almost indiscriminately; as they generally run for 10 or 15 years, it is perhaps a little better to speak of them as "bonds."

into receivers' hands and become almost a total financial wreck, it cannot afford under any conditions to give up its rolling stock, and must therefore maintain its annual payments. For this reason it happens that the equipment trust bonds, even of railroads that are actually in receivership and that have defaulted on practically all of their other obligations, frequently sell on a basis of 5 to 6½%. The equipment trust bonds of sound railroad corporations are in great demand and sell customarily on a basis of 4 to 5%.

It has been at times suggested that the same principle might be more widely applied, as for instance in selling machinery and other essential equipment to manufacturing corporations. The difficulty, however, arises that outside the railroad field, transactions which could be financed by equipment trust obligations are of comparatively small size, and could not easily be standardized in such a way as to make them appeal to the investing public. The average investor, even though he may be a bank official and well acquainted with financial practice, does not care to spend much time in analyzing and investigating propositions that are put up to him when he goes into the market to buy a security. He wants to get something that is standardized and familiar. It is only after years of active effort that a new financial method ordinarily can be introduced. For this very reason there is, perhaps, a real opportunity which some one will sooner or later seize, to apply the equipment trust method more widely and thus facilitate the sale of many kinds of machinery.

Collateral Trust Bonds

The use of marketable stocks and bonds as collateral for short-time loans has already been noticed in the chapter preceding. The issue of long-term obligations based on similar security is, however, comparatively a modern invention. There is a fundamental distinction between the two.

Short-term obligations are ordinarily secured by stocks and bonds which are active and which the borrower holds temporarily for resale. Long-term bonds should never be secured except by stocks and bonds that it is intended to hold permanently. Ordinarily these securities, posted as collateral, are those of subsidiary corporations or of other corporations in which the borrowing company expects to maintain a permanent interest. Sometimes nearly all the stocks and bonds of subsidiary companies, held in the treasury of the parent company, are collected and posted in one lot. This is the case, for instance, with the Missouri Pacific \$10,000,000 issue of collateral trust bonds which is secured by the deposit of first mortgage bonds of subsidiary companies. Twenty of these companies are represented, one of which is operating a road only two miles long.

It is a somewhat curious fact that a collateral trust issue will generally sell at a much better price than will the stocks and bonds which are posted as collateral. The reason is to be found not only in the fact that the parent company is adding its quota of credit to the credit standing of its various subsidiaries, but also in the fact that the collateral trust issue is comparatively large and therefore commands more attention and a better market. Inasmuch as the amount and quality of the collateral posted is seldom examined with much care by investors, there is always a chance, unless the banking syndicate which sells the issue is very careful, that the collateral will eventually be found of less value than was originally supposed. The general public, in fact, has no method, ordinarily, of securing genuine information as to the status and prospects of subsidiary companies whose securities are posted. It must regretfully be admitted that the collateral trust device has sometimes been used to obtain credit for corporations that were not worthy of credit.

A collateral trust bond issue is the favorite method of

financing the purchase by one corporation of the securities of another corporation. The purchase may be made in the first place with temporary bank loans, which in their turn are repaid as soon as the collateral trust bonds can be sold to the investing public. It was in this way, for instance, that the Northern Pacific and Great Northern financed their purchase of stock of the Chicago, Burlington and Quincy Railroad Company. The collateral trust bond issue based upon this stock is highly regarded. In the same way the Atlantic Coast Line took care of the purchase of Louisville and Nashville stock, and the Union Pacific of the purchase of Southern Pacific, of Baltimore and Ohio and of New York Central stock.

While the collateral trust bond issue is used most extensively by railroad corporations, it is common also among public utility holding companies and is used to a less extent by industrial combinations. The customary rule is to make the collateral trust bond issue about 80% of the appraised market value of the securities posted as collateral. This is the same percentage that is commonly regarded as proper among banks in granting short-term collateral loans. However, there are some exceptions. For example, the Queensboro Corporation, which deals in New York City real estate, has outstanding an issue of first gold 4's, secured by a deposit of mortgages on New York City real estate to an amount at least equal to the bond issue.

Debenture Bonds

A debenture—to give its literal and also its technical legal meaning—may be defined as any acknowledgment of debt which, of course, implies a promise to repay the debt. In financial practice, however, the word has gradually become restricted until it now means only an unsecured promise to repay a debt. In England a distinction is made between de-

benture bonds, generally called simply "debentures," and debenture stock; debenture bonds are in fixed amounts (say £20, £100, £200, £1,000, etc.), while debenture stock may be transferred in any amount that may happen to suit the convenience of buyer and seller. Under English practice a man may hold debenture stock in an amount, let us say, of £1263 6s. 3d., and may sell, let us say £563 4s. 2d.; while of debenture bonds his holdings and his sales must be in fixed amounts depending on the conditions of issue. Thus it will be seen that in England the distinction between debenture bonds and debenture stock is much the same as between ordinary shares and ordinary stock.

The English practice and American practice in the use that is made of debentures is entirely different. In English practice the mortgage bond is not so nearly universal as in this country, and the debenture bond or stock takes its place. We may draw a loose distinction between the two systems by saying that the American practice favors the issuance of obligations which are primarily protected as to their principal by the issuing company's assets, and as to their interest claims by the issuing company's income; while in English practice, the bondholder is protected primarily as to his interest by the priority of his claim on the issuing company's income, and is protected as to his principal only by the general credit of the issuing company. There has been some little debate at different times as to the relative merits of the two systems. The American system is criticized on the ground that, after all, the only test of the value of a company's assets is the amount of income they yield, and the English system, therefore, is not only simpler but more logical. On the other hand, it is stated that, in case the English debenture holder fails to receive his interest payments regularly, he has no further claim on which he can fall back. Hartley Withers, a leading English authority, asserts that "mortgage rights, carrying with

them the power of foreclosure, are always desirable to complete the security of the debenture holder. . . . The absence of mortgage rights is a weakness in an otherwise watertight security.”*

The debate is of little more than academic interest, for the practice of each country is firmly established and is unlikely to be changed by any argument.

In the United States, debenture bonds are quite commonly used in railroad reorganizations, in the general scaling down of claims upon the assets and income of the corporation. There will be references to some such cases in connection with the later study in this volume of reorganization practice. In other cases, debentures have been issued by American corporations in high credit, simply because they preferred the simplicity of the debenture form, and were able by reason of their general credit to sell them on a satisfactory basis. This has been true in the past, particularly of the New England railroads, the New York, New Haven and Hartford, and the Boston and Maine.

Still another case that calls for debenture bonds exists when a small corporation which has a relatively small amount of tangible assets, but possesses good-will and other intangible assets of high value, desires to make a long-term loan. Inasmuch as a corporation of this type does not have the proper basis for either a mortgage bond issue or a collateral trust bond issue, it is likely to fall back on a debenture bond issue. This is especially true, for example, of publishing companies, many of which are well established and can conservatively put out a long-term loan and yet possess tangible assets of comparatively small and uncertain value. Following is a form of debenture bond which has recently been used by a small company of this type, and which is suitable for use in similar cases:

*Hartley Withers on "Stocks and Shares," p. 96.

TWENTY-YEAR SIX PER CENT DEBENTURE

THE.....COMPANY, a Corporation of the State of New York (hereinafter called the Company) is indebted and for value received promises to pay to the registered holder, the sum of

ONE THOUSAND DOLLARS

in lawful money of the United States, on or before August 15, 1931, and interest semiannually on said sum, at the office of the Company in the City of New York, at the rate of six per cent per annum, on August 15 and February 15 in each year. Such interest shall be cumulative and payable in priority to any dividends on the stock of the Company for such half-yearly period.

THIS DEBENTURE is one of a series of 47 debentures, all of even date, 27 being for the principal sum of \$1,000 each; three for the principal sum of \$500 each; 13 for the principal sum of \$100 each, and 4 for the principal sum of \$50 each, a total of \$30,000.

THIS DEBENTURE shall immediately become due and payable if a judgment or decree is rendered for the dissolution of the Company by any court having jurisdiction thereof, or if the Company is adjudicated a bankrupt or insolvent, or if an effective resolution is passed by the stockholders for the voluntary dissolution of the Company.

THIS DEBENTURE may be redeemed by the Company at any time at its face value, and interest earned and unpaid hereon, upon thirty days' notice in writing sent by mail or delivered personally to the registered holder hereof.

A REGISTER of the debentures shall be kept at the Company's principal office containing the names and addresses of the registered holders and particulars of the debentures by them respectively.

EVERY TRANSFER of this debenture must be in writing, signed by the registered holder, or his legal personal representative, and shall be delivered at the Company's principal office, and duly acknowledged, if required by the Company, and thereupon the transfer will be registered and a note of such registration entered hereon.

IN WITNESS WHEREOF the Company has caused this instrument to be signed in its name and behalf by its President, and its corporate seal to be hereunto affixed and attested by its Secretary, this 11th day of August, 1911.

.....COMPANY

By

President

Attest:

.....

Secretary

It is quite possible that, in many instances where small corporations are now borrowing up to the limit of safety at a bank and yet are cramped for funds, a small issue of debenture bonds could be marketed among people who are acquainted with the corporation and recognize its solidity.

Some debenture bonds, although not secured by the pledge of specific properties, are protected by especial provisions which may give them an advantage over holders of wholly unsecured and unprotected obligations in case of reorganization. For instance, the American Cotton Oil Company has outstanding an issue of debenture bonds the principal of which may at once become due, in case there is a default in payment of interest, at the option of a majority of the holders of the bonds. The American Tobacco Company's gold debenture 6's and 4's are not secured by lien or mortgage on properties, but a charge is imposed in favor of the trustees acting for the debenture bondholders, upon the property and upon all the present and future net incomes of the corporation. This gives the owners of these debentures an advantage over the owners of any subsequent debentures or obligations that the company may incur.

There are one or two curious instances of so-called debenture bonds issued in this country and in Canada, which are not, in fact, debentures at all, but possess what is here consid-

ered a preferable mortgage security. For example, the Canadian Niagara Power Company has outstanding an issue of 6% debentures, series "A" and "B" of which are secured by a first mortgage, and series "C" by a second mortgage. The Wabash Railroad Company has a third mortgage issue outstanding which is called "Debenture Bond Series 'A.'" Some of the Chicago and Great Western debentures, also, are really mortgage bonds. As has been remarked before, it is unsafe to place any reliance upon names unless they are used in a strictly legal sense. The use of the term "debenture" in all these companies is doubtless in order to facilitate the sale of the bonds in the English market.

Income Bonds

Income bonds may be briefly described as almost the exact opposite of debentures. The debenture has primarily a claim on income, with little or no specific security for the repayment of the principal. The income bond is usually secured as to its principal by a mortgage lien of some kind, but has no claim for interest payments except as and when the issuing corporation has a surplus of earnings over and above all prior claims. The income bond is a hybrid and frequently possesses few of the attractive features either of ordinary bonds or of stock. It is seldom accepted by investors from choice. Most of the issues of income bonds now outstanding are the products of reorganization. In the general scaling down of creditors' claims which attends every successful reorganization, some of the bondholders are likely to be required to give up their claim to a fixed income, and to accept the claim which is possessed by the income bond to a fixed income only when it is earned.

Theoretically, this arrangement is fair enough and offers junior bondholders of an insolvent corporation all that they can reasonably expect to obtain. When income bonds were

first issued extensively in the United States, during the numerous railroad reorganizations of the 80's, they were generally regarded as an ingenious and praiseworthy device, but later experience has not confirmed this favorable first impression. Difficulties continually arise out of the fact that the determination of net earnings in a large corporation is not a purely mathematical process, but involves much discretion and continually gives rise to differences of opinion. It is to the interest of the common stockholders, who usually have control of the corporation, to defer payments to income bondholders as long as possible, or until the time arrives when dividends may be distributed also to the stockholders. It is easy enough for them to prevent payment of interest on income bonds if they so desire, by instructing the auditor to charge many expenditures of a capital nature into operating expenses, thus reducing the nominal showing of net earnings.

The best-known case of this kind is that of the Central of Georgia Railway Company, which issued in its reorganization of 1895, three series of income bonds, all falling due in 1945. For several years the holders of income bonds, to whom no payments were made, protested that they were not receiving fair treatment. Finally, in 1913, after long litigation, an auditor was appointed by the court and found that the Ocean Steamship Company, all of the stock of which was owned by the Central of Georgia Railway Company, had been earning large profits which were never taken into the published accounts of the Central of Georgia Railway Company. The earnings of the Ocean Steamship Company were turned over to the parent corporation under the fiction of a "loan" which was never intended to be repaid. Counsel for the Railway Company did not deny the facts but argued on the strictly technical ground that so long as dividends had not been declared by the directors of the Ocean Steamship Company, it was impossible to include these earnings in the income account of the Central of Georgia

Railway Company. It is a relief to find that the court disregarded this shallow pretext and took the common-sense view that the earnings of the Central of Georgia Railway included the earnings of its subsidiary company. In this instance the income bondholders finally won their case and are now receiving payments of interest. It was, however, a long and hard battle which offers little encouragement to investors to put their money into securities of this type. It has been well remarked in this connection that "the income bondholder may find that he has purchased a lawsuit rather than a security."*

Sometimes the holders of income bonds are given some of the rights of stockholders. The income bondholders of the New York Railways Company, which owns a number of the surface street railway lines in New York City, have the right to elect five out of eleven directors of that company. In the latter part of 1914, an active campaign to secure the proxies of income bondholders was conducted by the president of the New York Life Insurance Company, with the cooperation of other investors. It was announced that this campaign was based on the belief that the bonds were entitled to more interest than they had been receiving and that it was desired to elect directors who took the same view. "It should be remembered," it was stated, "that these bonds are not cumulative, and any income to which they are fairly entitled not currently received is utterly lost, unless the court shall decide to order a new accounting from the date of reorganization. A suit calling for such action is now pending."

That holders of income bonds may sometimes have to content themselves for a long period without obtaining either income or a return of any of their principal is clear from the report of the Comstock Tunnel Company. This company has outstanding \$2,769,000 first income 4's, on which no interest

*Lyon on "Capitalization," p. 40.

has been paid since 1892. An extraordinarily weak claim is that of the Reading deferred income bonds, which are not entitled to interest until after the common stock has received 6% dividends.

Although new issues of income bonds have been rare in recent years, the Hudson and Manhattan Company put out in 1913 a series of contingent income bonds. In industrial corporations they are rarely to be found. Out of 40 or more industrial security issues discussed in Dewing's "Corporate Promotions and Reorganizations," only two are income bonds, those of the Mount Vernon-Woodberry Company and the Standard Rope and Twine Company. The Mount Vernon-Woodberry bonds were secured by a second mortgage on all the fixed assets and a direct lien on all the merchandise and quick assets. They proved a constant source of controversy and greatly handicapped the company in securing short-term bank credit which is especially essential in textile manufacturing. The indenture of these income bonds was faulty in that it made no provision for allowing depreciation before figuring net earnings, thus giving rise to many impossible demands on the part of the dissatisfied income bondholders.*

Income bonds and stock are used to a limited extent also in English practice. The same objections, however, have arisen there as in this country, and the tendency is in favor of other securities which give less room for misunderstanding and controversy. The Lancashire Power Construction Company, Ltd., has outstanding an issue of income stock which was issued as a bonus to subscribers to debenture stock. The income stock is entitled to 75% of the net profits after deducting interest on bonds and debentures, and the principal is repayable, in case the company is wound up, after prior debts have been liquidated.

*Dewing's "Corporate Promotions and Reorganizations," pp. 340, 363, 606.

Convertible and Participating Bonds

Most purchasers of the bonds of high grade companies are primarily interested in the safety of their principal plus a moderate rate of return. Most purchasers of shares, on the other hand, are primarily interested in securing profits due to the enhancement of the value of their holdings, plus as high a rate of return as they can secure. If they purchase stock with their eyes open, they realize that they are voluntarily incurring more or less risk. Between these two main bodies of purchasers of corporate securities, there are a great many investors who wish to secure reasonable safety combined with a reasonable chance for appreciation in the value of their holdings. Preferred shares are intended in part to meet the wishes of this intermediate class. Convertible and participating bonds are designed also to appeal to this group.

The adjective "convertible" in itself has no definite meaning. The bonds may be convertible into anything on any terms. Ordinarily, however, the convertible feature gives to bondholders the privilege of exchanging their bonds within certain time limits and at a rate fixed in advance, for the corporation's common shares. The bondholder may reason that he secures under this arrangement a sound and safe security which yields a moderate rate of return and in addition has a chance of speculative profits due to the possible enhancement in the value of the company's shares. Thus, the Union Pacific Railroad Company's issue in 1901, of \$100,000,000 of 4% bonds, which were convertible into common stock at par before the expiration of this conversion privilege, sold considerably higher than par. Practically all of this issue was converted and its holders obtained a sizable profit. It has not been unknown for original purchasers of these securities to obtain profits in this manner running as high as 25 to 50%; this is in addition to the normal rate of interest on their investment.

There is, of course, the corresponding drawback that the conversion privilege, if it is really valuable, increases the selling price of the bonds and this lowers slightly the yield on the investor's capital. However, in view of the fact that the large buyers of bond issues are institutions which are not attracted by the possibility of speculative profits, it has been found that those who were willing to purchase the convertible bonds of good companies are frequently able to get them at a very reasonable price. There are, of course, all shades of variations in the attractiveness of convertible bonds. The Pennsylvania Railroad Company has put out some issues which are convertible into common stock at such a high rate of exchange that there seems to be no probability that the conversion privilege will become valuable.

From the corporation's point of view there are obvious objections. It may well be argued that the company is taking the chances. If its business moves along successfully and its stock increases in value, the holders of convertible bonds share in the prosperity without having shared in the preliminary risks. On the other hand, in case some unforeseen misfortune reduces the company's earnings, the convertible bondholder naturally enforces his claim with the same rigor as any other creditor. As a matter of fact, convertible bonds are seldom issued except in periods when the demand for capital is large and when it is necessary for corporations—even those in highest standing—to make concessions. In the United States, these securities were first issued during and after the Civil War. The financing of the Chicago, Milwaukee and St. Paul Railroad Company from 1860 to 1880 was chiefly effected through issues of convertible bonds, and it is stated that as late as 1896 there were twelve separate convertible issues of this company outstanding. From 1880 to 1900, on the other hand, the practice was discontinued and was generally thought to have become obsolete. Since 1900 there has been a revival

of convertible issues, which is to be explained chiefly on the ground of increased demand for capital.

Among the convertible bonds now outstanding may be mentioned :

Atchison 4's, due 1955, which were convertible up to June 1, 1913, into common stock at 100.

Union Pacific Debenture 4's, due 1927, convertible prior to July 1, 1917, into common stock at 175.

American Telegraph and Telephone Company's debenture 4's, convertible up to March 1, 1918, into stock at 133.7374.

Participating bonds attempt to offer a like advantage by giving to the bondholders a right to share in excess profits after all the obligations of the company have been provided for. They are like income bonds except that it is obligatory on the part of the company to pay the fixed rate of interest, and the participating feature applies only to excess payments. The best known issue of this kind was the "Oregon Short Line Cumulative Trust Participating 4's" issued in 1903 but almost immediately retired, which were to receive 4% interest plus whatever dividends in excess of this amount were declared upon the stock of the Northern Securities Company, deposited as collateral.

An English issue of the same type consists of the profit-sharing debentures of the Anglo-Netherlands Sugar Corporation, which bear interest at 5% and in addition are entitled to 25% of the surplus net profits remaining after the sinking fund has been provided for and after 5% has been paid on ordinary shares, "such participation, however, being limited to an additional 2½%." In other words, these debentures cannot under any conditions pay more than 7½%. Participating and profit-sharing bonds have not proved especially popular either in the United States or in England.

Sinking Funds

The sinking fund principle first came into prominence in the latter part of the eighteenth century, when it was advocated and applied by William Pitt as the best and easiest means of providing for the repayment of the United Kingdom's huge national debt. It was heralded by many people at the beginning as a remarkable method of repaying the loan without any perceptible sacrifice. As a matter of fact, this is in many instances the truth of the case. Corporations are run by human beings who are more than likely, if left to their own devices, to make inadequate provision for the future. An officer of a corporation which has just floated, let us say, a 25-year loan, is likely to consider that his duty has been done; his corporation has received a large amount of fresh capital which can be profitably used, and the earnings of which (after deducting the interest payments) will go to increase the yield on outstanding stock. It is easy for him to think that it is not his part to worry as to the repayment of the loan. When it begins to approach maturity, he, or his successor, will consider how it should be handled.

Against this every-day human attitude of directors and managers of borrowing corporations, there are opposed the interests of the buyer of the bond and of his representative in the preliminary negotiations, namely the banking firm which undertakes to dispose of the bond issue. The investor wants to make sure that his money will be repaid when due. Further than that, he wants to make sure that there will be no depreciation in the market value of his holdings. He is well aware, as every lender must be, that the borrower's natural instinct is to let the future take care of itself. If he is wise, he is strongly inclined to insist that some definite measures be adopted which will fully protect him against the carelessness or easy-going optimism of the people to whom his money has been entrusted.

This wise demand on the part of the investor can readily be met without great difficulty. The fundamental reason for the sinking fund or some other method of beginning at once to repay a loan, is to be found in the fact that comparatively small amounts set aside each year out of the corporation's earnings will assure repayment, unless the corporation has overborrowed. The annual provision, accumulating as it does at compound interest, will not be a serious burden. Accumulating at the rate of 6%, a sinking fund of approximately 4.3% per year will provide for repayment of a loan at the end of 15 years; accumulating at a rate of as little as 3%, a sinking fund of 2.8% per annum will provide for repayment of a loan at the end of 25 years.

A corporation should be able to withhold these amounts and yet have ample funds remaining, if it is reasonably prosperous, for dividends to its stockholders. It is clear from the approximate figures cited, that the repayment of a loan by annual deductions from income is especially appropriate in the case of loans running from 20 to 50 years. The length of the loan will, of course, depend upon the character and stability of the business. A loan to a railroad company may properly run, it is generally considered, for as long as 50 years. A loan to an industrial corporation will ordinarily not run longer than 25 years. Inasmuch as the profits of industrial corporations are expected to average higher than the profits of transportation companies, it is clear that they should be able to carry a larger sinking fund.

Although many corporations combat the tendency, there can be little question but that the demand for some form of sinking fund or other annual repayment is growing. The Committee of the American Investment Bankers' Association on Railroad Bonds and Equipment Trusts, included among its recommendations at the 1915 meeting of the association, that "railroad mortgages should contain provisions for sinking

funds, and that such sinking fund payments should be recognized by the rate-making bodies as an operating expense of the railroad corporation."

In popular usage the term "sinking fund" is applied almost indiscriminately to any method of providing for repayment of a long-term loan during its life, by setting aside a predetermined amount at regular periods for that purpose. This process is known in more technical language as "amortization." In its proper sense, amortization includes four principal methods as follows:

1. The borrower may turn over fixed cash payments at regular periods, usually once a year or once every six months, to a trustee; the trustee may deposit or invest the money at his discretion within the limits determined in the original agreement.
2. The borrower may set aside fixed sums at regular intervals and deposit or invest these sums at his own discretion within the limits of the agreement.
3. The borrower may set aside sums at regular intervals and use them solely for the repurchase of the bonds which are being amortized.
4. The bonds may be arranged to mature in series so that a predetermined proportion will fall due each year, thus forcing the borrower to repay the bonds gradually during the life of the whole issue.

The first two methods are the ones originally in view under the sinking fund plan. They are still used to a considerable extent in the repayment of municipal and some other governmental loans, but are seldom to be found in private corporations. The third and fourth methods are in one important respect similar, since the sums set aside out of income are used under both methods for the redemption of the borrower's own obligations, not for the purchase of outside securities. In

applying the third method, the bonds which are repurchased by the corporation are frequently kept alive. Interest payments on them are maintained, in which case it may properly be designated as one variety of sinking fund. In other instances the bonds that have been redeemed are cancelled, in which case the third method closely resembles the fourth method.

There are certain objections to all these methods which may briefly be stated. When the first-named plan of turning over regular payments to a trustee is followed, there is always to be considered the possibility that the trustee may invest the funds with a view primarily to his own advantage, or may make unsound investments, in which case it is quite possible that the fund may not accumulate as rapidly as had been expected in advance. The possibility of making unwise investments is almost equally to be feared under the second method. Furthermore, the average rate of return on high-class investments varies considerably over a long period of years, and this may make impracticable even an approach to the rate of accumulation which had been calculated in advance. It is, in fact, a matter of common knowledge that sinking funds invested in outside securities seldom come up to the expectations of those who plan them. The final, and perhaps most serious, objection to both the first and second methods is that high-grade investments, which are the only ones suitable for sinking funds, yield a comparatively small rate of return; as a matter of fact, the rate of interest received on such securities usually is considerably less than the interest which is being paid by the corporation on its own obligations.

These objections have proved so powerful and well founded, that it has come to be almost universally accepted as correct practice to carry on amortization through the redemption of bonds which are being amortized. The practical question for most corporations to consider is whether it is best to set aside fixed amounts for the redemption of their securities,

or to arrange for serial maturity of these securities. For short-term loans the tendency is strongly toward the convenience and simplicity of the last-named method. For long-term loans, however, the third method is probably better adapted. There are two fundamental reasons for this preference: first, when an issue of long-term bonds has different dates of maturity, it is necessary to fix a distinct price for each maturity, which is inconvenient and in large part offsets the advantage of ready marketability which should attach to all large bond issues; second, unless the amount falling due at each date of maturity is arranged on a graduated scale so that the amounts become progressively larger, the burden on the corporation is heavier at the beginning when interest payments on the whole issue must be met, and is gradually lightened as more and more of the bonds are redeemed and interest payments are thereby reduced. It is far better, if possible, to retain the advantage of uniformity in the life of all the bonds in one issue, and of an equal distribution of the burden over a period of years, both of which are attractive features of the original sinking fund plan.

The simplest and no doubt the favorite device for meeting all these objections, is to establish a sinking fund and invest the fund solely in bonds that are being amortized. Among the beneficial results of this method are the following:

1. The corporation is protected against any loss due to unwise investment, when it is buying its own bonds, and thereby reducing its outstanding obligations. It is certainly in no danger of losing its money.

2. The rate of interest earned is the same as the yield of the market price of the bonds that are being amortized. This is an accurate statement, at least under the customary provisions that the bonds may be redeemed for the sinking fund at par or slightly above, or may be purchased in the open market at the option of the corporation, in case the market price is below the fixed redemption price. If the bonds are

selling on a 6 or 7% basis, it is clear that the sinking fund will accumulate at the same rate.

3. Under the customary provisions just referred to, the market price of the bonds is maintained by the corporation's repurchases or redemption, and in this way the credit of the corporation is supported.

4. There is nothing to prevent making a single quotation for all bonds in the issue. If a corporation buys in the open market, it takes whatever bonds happen to be for sale at the market price. If it redeems a fixed proportion of bonds each year, the bonds to be redeemed are customarily determined by lot. In this last practice there is a slight element of uncertainty which might be considered objectionable, but it is of small practical importance.

5. The burden on the corporation is equally distributed during the life of the bond issue. The simplest plan for accomplishing this result is to keep alive all the bonds purchased for the sinking fund, so that the corporation pays out the same amount of interest each year. As the number of bonds held in the sinking fund increases more and more, interest payments, it is clear, go to swell the sinking fund, and thus to increase the annual purchases or redemptions. But so far as the burden on the corporation is concerned, it remains the same year after year.

There seems to be little room for question that among all the methods of amortization, the best and simplest is the one just described of establishing a sinking fund which is used for the repurchase and redemption of all the bonds that are being amortized, and keeping alive the bonds that are taken into the sinking fund.

A Novel Proposal

It may be of interest to readers in connection with the preceding review of sinking fund methods, and as showing

how the principles that have been stated are applied in practice, to review briefly a somewhat novel proposal for the redemption of a bond issue which was presented to the writer some years ago. The proposal may be regarded as typical of a number of ingenious plans which on analysis are generally found to be unsound.

The essential points of the proposal may be stated as follows:

A manufacturing concern, a corporation, wishes to increase its working capital by \$400,000. It has at present about \$300,000 worth of paper in the banks and desires to make this a permanent loan in order to be able to take care of future increase of business by additional bank credit if it should be necessary. The plan under consideration is the issue of \$400,000 of 50-year 6% debenture bonds without any mortgage, secured by a general charge against the property.

A redemption fund is to be provided by the corporation's procuring a trust company to act as trustee for a fund of \$72,000. This is to be invested at the trust company's discretion, so that it will yield 4% per annum, and the above amount at this rate, compounded semiannually, in fifty years will amount to \$520,000, or \$120,000 more than sufficient to pay the bonds at maturity.

The borrowing corporation would therefore receive from this issue \$328,000 and at the expiration of the 50-year term \$120,000 additional.

The trust company's remuneration is to come from whatever it can make above 4% on this \$72,000.

Will you give me your opinion as to whether you would consider this good business on the part of the corporation and what you would think of the bonds aside from the question of the credit of the borrowing company.

In putting this matter before a trust company to act as trustee, for the redemption fund, what objections, if any, would likely be made? Do you know of any bond issues of this kind?

The reply to this inquiry was as follows:

Your plan for providing for the ultimate redemption of a bond issue, is unusual. We do not know of any bonds issued under similar conditions. For the reasons presented below, the plan seems to us wasteful and objectionable.

First, and most important of all, it would seem to us very unwise to turn over \$72,000 to any individual or institution to be invested at the discretion of the trustee, with the provision that the trustee is to retain as profits whatever income is secured above 4%. Under this arrangement the trustee is given every inducement to secure just as large an income as possible, even if the principal be risked. In other words, the trustee is left free to speculate with other people's money.

It may be claimed, on the other side, that a highly reputable conservative trust company would be chosen as trustee and that this trust company would be responsible for the original sum with interest compounded at 4%. But you must remember that 50 years is a long time and that no man can foresee what changes in ownership and management may take place before the end of the period.

Moreover, 4% is about all that can be secured on thoroughly safe investment bonds at the present time. The proposed plan, therefore, would make it imperative on the trustee to invest in more or less doubtful securities. Under these conditions, we doubt very much if any first-class trust company would consent to act as trustee.

The rate of return on sinking funds invested in outside securities is always uncertain, and, as experience has shown, almost always disappointing. The best modern practice in handling sinking funds, therefore, is to invest them in the very bonds which the sinking fund is designed to protect. These bonds may be secured either by purchase in the open market or by providing at the beginning that they may be called and redeemed at a good price, usually considerably above par. As bonds backed by sinking funds usually bear comparatively high

rates of interest, this method of investment is not only safe, from the corporation's standpoint, and the returns certain, but also results in a much larger saving than is possible by conservative investment in outside securities. In the present case, for instance, a sinking fund so invested would yield a return of 6% instead of 4%.

Another criticism of this bond issue is that the life of the bond is too long. Scarcely any industrial corporation is so firmly established that its bonds can safely be bought when they run over a 50-year period—not, at least, unless some of the bonds, as with the United States Steel issue, are bought up and put into the sinking fund each year. For this reason alone we do not believe that the bonds under the proposed plan would find a ready market.

Another objection is that the proposed plan is expensive. The corporation, assuming that the bonds are sold at par, will secure \$400,000, \$72,000 of which will go into the redemption fund, leaving only \$328,000 for the company. The \$72,000 will draw only 4%; yet the company must pay 6% on the whole \$400,000.

The net expense to the corporation consists of the yearly interest payment less the annuity which, if set aside each year and invested at 4%, would equal \$120,000 at the end of 50 years. This annuity is \$786.02. The net expense to the corporation, therefore, is \$24,000 less \$786.02, which equals \$23,213.98, equivalent to 7.08% on the \$328,000 actually received.

If, instead of the redemption fund, the ordinary sinking fund invested in outside securities at 4% were used, the yearly expense would be as follows:

6% on \$328,000.....	\$19,680.00
Plus sinking fund yearly payment which accumulating at 4% would equal \$328,000 at the end of 50 years.....	2,148.47
Total.....	<u>\$21,828.47</u>

This latter sum is 6.65% on \$328,000.

If the sinking fund, as suggested above, were invested in the corporation's own bonds, there would be a still greater saving. The exact amount of this saving would depend on the price at which the bonds were redeemed or bought in the open market, and cannot, therefore, be calculated precisely in advance—not at least unless the rate of redemption is fixed at the time the bonds are issued.

Other Methods of Safeguarding Bonds

The bond issues put out by mining companies, lumber companies, and other concerns, the chief property of which consists of "wasting assets"—that is, assets which in the ordinary course of business are used up and not replaced—are customarily protected by sinking funds calculated on the annual wastage. Timber bonds, for instance, which are secured by tracts of standing timber, are customarily issued up to about 50% of the market value of the timber. The mortgage securing the bonds must contain strict provisions which operate to insure the regular deposit of an agreed amount per thousand feet for all timber cut sufficient to retire all the bonds when about one-half of the timber is consumed; these deposits to be applied to the payment of principal of the bonds as the several serials, semiannually or annually, become due. The mortgage makes provision for keeping careful check upon the cutting of the timber and accounting for the same to the mortgage trustee.*

\$3 to \$3.50 per thousand feet of lumber seems to be generally regarded as a fair sinking fund provision. The same principle is followed in accumulating sinking funds for mines. For example, the Great Lakes Coal Company sets aside for this purpose, 5 cents per ton, run of mine coal. The Iroquois Iron Company sets aside 25 cents for each of the first 400,000 tons of iron ore mined and shipped each year, with an addi-

*Extract from circular issued by Messrs. Clark L. Poole and Company, quoted in T. S. McGrath's "Timber Bonds," p. 34.

tional 15 cents per ton on all shipments running in excess of 400,000 tons.

There are many different special provisions for the maintenance of sinking funds and for giving greater security to bondholders. In 1899 the New England Cotton Yarn Company issued \$6,500,000 5% first mortgage bonds which were covered by a sinking fund of 1% on the outstanding amount, payable before any dividend disbursements on the preferred stock, with an additional sinking fund of 4% payable before any dividend disbursements on the common stock. The Baldwin Locomotive Works has an authorized issue of \$10,000,000 first sinking fund gold 5's, the mortgage of which provides that the net quick assets of the corporation shall at all times equal the aggregate indebtedness including the outstanding bonds. Similar provisions requiring that net quick assets shall bear a fixed relation to the total indebtedness are not uncommon with manufacturing and trading companies.

CHAPTER VIII

BASIS OF CAPITALIZATION

Definitions

We have now considered the financial forms of organization of business enterprises and the various types of security issues which are exchanged for cash and other property acquired by the business. The total par value of all the security issues outstanding at any given time is usually referred to as the "capitalization" of an enterprise. In some jurisdictions there is a legal meaning attached to the word "capitalization" which is wholly distinct from its popular meaning; it being, in the legal sense, the total par value of the authorized capital stock of a corporation. Wherever the word is used in this volume, however, it may be understood in its popular sense.

"Capitalization" is distinguished from "capital" or "capital funds," by which we mean the actual value of the investment in the business. The vague expression "overcapitalization" is intended to indicate a state of affairs where the nominal value of the outstanding stocks and bonds is in excess of the real value of the investment. It has already been pointed out in discussing methods of paying for capital stock, that there need not necessarily be a close correspondence between "capitalization" and "capital" or "capital funds" actually invested.

Another phrase frequently used which should be distinguished, is "capital assets," under which term are included those assets of a business which are of a permanent nature and which are essential to its continuance. "Capital assets" are distinguished from "current assets." If a manufacturing concern, for instance, has a plant worth \$1,000,000, inventories of \$300,000, and cash and accounts receivable of \$200,-

000, we should say that its capital assets were \$1,000,000 and its current assets \$500,000.

The capitalization of an enterprise is in a sense a valuation on the part of the organizers of the net worth of the enterprise. At the beginning it is supposed to be, at least as a matter of legal theory, a fairly accurate valuation. As time goes on, it is recognized that there will necessarily be changes in the status and value of the various assets and liabilities; and the financial results of these changes are supposed to be shown in the surplus or profit and loss accounts. The "capitalization" plus the surplus theoretically measures the exact value of the permanent investment in the business. However, the necessary inaccuracies and arbitrary estimates of accounting practice make it very difficult even to approach this theoretical relation in every-day practice.

Three Bases of Capitalization

The question: "What is the right basis of capitalization?" is almost identical with the question: "What is the best measure of wealth?" To this latter question there are three possible answers. The most obvious is that wealth is measured by the cost of the property which is owned, plus whatever surplus value has been accumulated. Thus, if a farm cost \$10,000 and has been improved to the extent of \$500 a year, it should, in the course of two years, be worth \$11,000. But, supposing that before the end of the two years some one in the neighborhood struck oil? The property would immediately acquire a value which would have very little reference to the original investment in the accumulation of betterments. Unexpected factors wholly outside the control of the owner of property are continually modifying its value so that it is quite out of the question for anyone to depend wholly on records of his investments and of accumulations as a method of measuring his wealth.

The second method is to measure wealth by the cost of reproducing property. If a man has a factory which has been running for 20 years, he may be ready to grant that his records of investments and accumulations would be of little use in determining its value but he might suggest that the present cost of building another plant of the same quality and size would be a correct measure of its value. This may be accepted as satisfactory so far as strictly tangible assets are concerned. But to every piece of property there attaches a certain intangible value. A man running a successful retail shop would not be willing to part with it, ordinarily, in exchange for another shop which was just as well fitted up and carried the same stock but which had been unsuccessful. A street railway company that was running smoothly and in harmony with the public sentiment of its territory would not accept in exchange for its track and rolling stock the exactly similar assets of some other company which had incurred public ill-will. It is possible—at least theoretically—to reproduce physical assets, but it is impossible to reproduce goodwill, organization, prestige, and the like. Hence, the attempt to measure wealth by figuring the cost of reproducing properties breaks down as soon as we begin to measure the value of intangible assets.

The third method is the capitalization of earning power. One man owns a piece of real estate, which brings him a clear net income under a long-term lease, of say \$50,000 a year; another man owns a piece of property for which he paid just as much but which yields only \$10,000 a year. Assuming that these two incomes are equally stable, can there be a question in anyone's mind that the first property is worth five times as much as the second? Note the assumption that the two incomes are equally stable. The likelihood of continuance of earning power and the ease with which it may be transferred are, of course, important factors to be considered. To what

extent they should be allowed for, and in what way the value of any given property is to be determined on the basis of its earning power, are questions to be discussed a little farther on in this chapter. It is enough here to point out that earning power is the chief result of tangible and of intangible assets. If we take into account not merely current earnings but also potential earnings, then we have here a measure of wealth which must be a true and satisfactory measure. After all, in buying property for business reasons, what do we buy? Not merely so much real estate or so many articles. We are buying income. In the same way a man's individual wealth is shown, not by what he has invested—which may have been chiefly wasted—but by what he is getting out of his investments. If the answer that earning power is the best measure of wealth is granted, and if the proposition that "capitalization" of an enterprise is an approximate estimate of its wealth is accepted, then it would seem to follow that the correct basis of "capitalization" is earning power. This answer, however simple and sound it may appear to us, is not a principle of the law governing corporations which, on the contrary, assumes that investment is the only correct basis of capitalization. Out of this conflict between legal theory and business practice grow many difficulties and evasions.

Investment as a Basis of Capitalization

Small and close corporations are usually started through informal agreements among a few men who are personally acquainted with each other. Each one of these men subscribes to a certain amount of stock of the new corporation and pays for his stock either in cash or by turning over property at a value agreed upon with his associates in the enterprise. With comparatively few exceptions, corporations of this type issue their bonds and capital stock at a par value exactly or nearly equivalent to the cash or cash value which the corporation

receives. Thus at the beginning there is an actual correspondence between the capitalization, the investment, and the actual net worth of the corporation's assets. If the enterprise operates along well established lines, has the correct amount of capital, and earns a normal rate of return, there will be little divergence from this system of approximate equality among the three factors mentioned. Ordinarily, however, the vicissitudes of business soon bring about variations. With a larger corporation there is usually no very close correspondence, even at the beginning. It has been remarked: "New companies nearly always start with a burden on their backs. Either they have to spend a great deal in order to get their capital, or they pay a great deal for the good-will of an established business."*

The wide discrepancy that may exist between investment and actual value is most forcibly illustrated by the history of the so-called "Cordage combination" which began as the National Cordage Company in 1887, became after the first reorganization in 1893 the United States Cordage Company, and after the second reorganization in 1895 the Standard Rope and Twine Company. Arthur F. Dewing has calculated the results to the original investors in this unfortunate enterprise as follows:

For purposes of illustration consider a private investor having bought ten shares of the National Cordage Company's preferred stock of Belmont & Co. in 1890. In the reorganization of the National Company he was compelled to buy twenty per cent more of the preferred stock, all of his holdings becoming second preferred. He would, therefore, come into possession of twelve shares of the United States Cordage Company's second preferred stock—cost \$1,200. He received no dividends. In the reorganization of the United States Cordage Company, the second preferred stock was as-

*Hartley Withers on "Stocks and Shares," p. 74.

sessed \$10 a share and received \$10 a share of the First Mortgage Bonds of the Standard Rope and Twine Company and forty per cent of stock. The investor in question would be assessed \$120—making his actual investment \$1,320. He received \$120 in the Standard Rope and Twine Bonds and \$480 in stock. In the reorganization of the latter Company the stock was extinguished. The bonds were worth thirty-nine per cent and, if retained, would be subject to an assessment. The \$120 in bonds represented an actual value to the investor of \$46.80. Meanwhile, he would have lost the interest on the investment for upwards of twelve years. Taking this at the rate of five per cent the indirect loss amounted to \$780. A man who invested \$1,000 in the first and underlying security of the National Cordage Company would, in 1905, have increased his actual investment to \$1,320, and including interest to \$2,100. For this he would have stock that was worthless and bonds having a market value of \$46.80 and subject to further assessment.*

On the other side may be given numerous examples of corporations the fortunate stockholders in which have seen the market value of their shares rise with great rapidity. It needs no further argument to satisfy every one that however closely investment, capitalization, and net worth may correspond at the beginning of an enterprise, they are likely to diverge more and more as time goes on.

Capitalization of Initial Expenses and Losses

A question which arises in the early history of most corporations, and which is of considerable practical importance, concerns the propriety of capitalizing initial losses and expenses. Every new corporation must expect to incur a loss during the period between the time it starts operations and the time its business is on a normal basis. This period may

*Dewing's "Corporate Promotions and Reorganizations," pp. 159-162.

be long or short, depending upon the nature of the business. With many companies such as railroads, large manufacturing establishments, publishing concerns, developers of urban real estate, and the like, the period is apt to be several years in length. With trading companies the period should be relatively short. The excess of expenditures over income during this period is frequently charged to some capital account or accounts, such as "Development Expenses," "Organization Expenses," "Good-Will," or "Deferred Expenses." When a business comes to be on a normal basis and is earning profits, then initial expenses and losses may either be written off or may be transferred to some permanent capital account, thus providing a basis for a later increase in capitalization.

The same question arises in connection with interest payments on bonds that have been issued during the process of construction and development of a company and in connection with discounts on bonds sold below par. In a well-known English case it was decided in 1906 that "where a company borrows money to construct permanent works the interest paid during the period of construction might properly be treated as a part of the cost of construction and charged to capital."*

The English Companies' Consolidation Act of 1908 specifically provides that where shares are issued to defray expenses of construction, the company may pay interest on such shares and charge the payments to capital accounts, with the provisos that the payment be authorized by the stockholders and by the Board of Trade; that it shall not continue more than six months after construction is complete; that the rate of interest shall not exceed 4%; and that the transaction be clearly shown in the company's books of account. In this country much the same practice is found as in England, although it is not so definitely authorized.

**Hines v. Buenos Aires Grand National Tramways*, 2 Ch. 654; quoted in Gore-Brown and Jordan's handbook on "Joint-Stock Companies," p. 283.

There seems to be no serious objection to be urged, although the practice may sometimes favor abuses. Examples might be cited of companies which have little or no prospect of success and yet have gone on for a period of four or five years charging the losses on their normal operations to a fictitious capital account, thus rendering a forced statement of alleged profits to their shareholders. These isolated abuses, however, are hardly to be taken as sound objections to a practice which is in itself correct. We are probably quite justified in saying that the total investment in an enterprise includes a reasonable allowance for expenses and losses incurred in carrying through the initial organization and development.

Capitalization of Earning Power

We have already touched upon the fundamental reasons for regarding earning power as the proper basis of capitalization. This principle is generally accepted as correct in the United States, England, France, and other commercial countries except Germany, wherein the laws insist with much strictness on a close correspondence between capitalization and investment. Speaking on this point, Paul M. Warburg, now a member of the Federal Reserve Board, wrote several years ago:

Stock-watering, that is, capitalization of earning power or good-will, is permitted in England and France, while it is not allowed in Germany. While personally I prefer the German system, it is a mistaken idea to think that the capitalization of earning power necessarily means taking advantage of somebody. If the German sells at 200% an industrial stock paying 10% dividends, it amounts to the same as if the Englishman had sold at par twice the amount of shares on which 5% dividend is paid.*

*Quoted from article on "American and English Banking Methods Compared," by Paul M. Warburg, in *North American Review*, 1908.

Capitalization on the basis of earning power is not necessarily the result of a carefully thought-out plan. On the contrary, it usually is the by-product of an effort on the part of the managers of corporations to make their holdings as attractive as possible so as to be able to sell them at the highest possible price. It is for this reason that corporations which have shares that are actively dealt in are more generally capitalized on an earning power basis than are the corporations which are closely held. It has been found through long experience that shares which sell at or below par have a readier market and command a higher price in proportion to their yield than do shares which are quoted far above par. If a company is showing earnings of 40% on its common stock but is paying only small dividends, it will be found difficult, in all probability, to sell such shares at a price commensurate with their intrinsic value. But, if the same company through some device quadruples its capitalization so that the earnings on each share amount to 10%, it may safely be assumed that the new shares will sell for more than 25% of the market price of the old shares.

There is very little, if any, sound reason for the preference generally shown for shares that sell near or below par. Two explanations, however, may be offered: First, there is a somewhat wider market for low-priced shares, due to the fact that they are usually bought and sold in lots of 10 or more; it is obvious that there are more people who can buy a lot of 10 shares worth \$40 each, than a lot of 10 shares worth \$400 each. Second, there is an impression in the mind of the average shareholder—a vague impression but powerful—that his stock either had or will have a real value about equivalent to its par value. If he buys below par, he sees a prospect, at least, of appreciation in the value of his holdings. This impression, we may grant at once, is based on a misconception. Many shareholders do not seem fully to understand that their

property rights consist, practically, only of an equity, and that the corporation is under no obligations ever to return or account for the par value of their shares. Nevertheless, there is an imaginative appeal in the magic term "\$100" stamped on the face of a stock certificate, which undoubtedly helps to sell low-priced shares.

The rate of capitalization of earning power of a corporation depends naturally on the corporation's stability and on the nature of the business. A railroad or public utility company may find stock which yields only 5 to 7% selling at or near par. The shares of a manufacturing or trading company must usually earn 8 to 12% or 15% if they are to sell at par. These percentages do not refer solely to dividends, but to the actual net earnings of the corporation after all claims prior to dividends on the common stock have been met. There is, of course, no definite rule for determining what percentage should or will be used in working out the capitalization. That must be determined by observing the market action of the company's shares and of other similar shares.

There is a perceptible tendency, which it is interesting to bear in mind, toward establishing an approximate equality between the outstanding capitalization of a company and its gross earnings. Note that the relation is with gross earnings, not with net earnings. When the F. W. Woolworth Company (owner of the well known chain of 5 and 10 cent stores) was incorporated in 1912, the estimated earning capacity was capitalized at \$50,000,000, or over 80% of the entire capital stock. This figure was almost equivalent to the company's gross sales of the preceding year.

Following is a compilation showing the stocks and bonds outstanding in the hands of the public, the gross sales, and the percentage of gross sales to outstanding capitalization in each case:*

*Adapted from article in *Wall Street Journal*, August 26, 1915.

Company	Total Capitalization	Gross	Proportion of Gross to Capitalization
General Motors.....	\$39,338,983	\$85,373,302	2.17
American Smelters.....	158,976,498	200,925,625	1.26
General Electric.....	83,885,987	90,467,691	1.08
American Tobacco.....	73,139,626	69,339,083	.95
Westinghouse	46,967,444	33,671,485	.72
Pressed Steel Car.....	21,866,665	13,375,090	.61
American Locomotive.....	56,702,530	29,987,438	.53
U. S. Steel.....	1,498,643,673	558,414,933	.37
Republic Iron & Steel.....	69,180,414	21,366,249	.31
Baldwin Locomotive.....	48,390,523	13,616,163	.28

It will be noted that the five companies at the bottom of the list above, had all been going through a period of exceptionally slack business when this table was compiled. Ordinarily their gross would run a great deal higher. Making this allowance, we find only one radical exception in the above table to the general rule that capitalization and gross earnings tend toward an equality. This exception is the General Motors Company, the stock of which is selling at a high price; it is rumored that this company is likely to increase its capitalization at the first good opportunity.

The correspondence applies chiefly in manufacturing and trading operations and not at all in the railroad or public utility field. This may best be shown by the following tabulated comparisons of capital, gross returns, net returns, and percentage of net returns to capital, as shown by the United States Census returns for 1900, 1905, and 1910:

MANUFACTURING ESTABLISHMENTS

Year	Capital	Gross Returns	Net Returns	Percentage of Net Returns to Capital
1900	\$8,975,256,000	\$11,406,927,000	\$1,536,502,000	17
1905	12,675,581,000	14,793,903,000	1,655,643,000	13
1910	18,428,270,000	20,672,052,000	2,218,972,000	12

RAILROADS

Year	Capital	Gross Returns	Net Returns	Percentage of Net Returns to Capital
1900	\$10,263,313,000	\$1,487,045,000	\$477,284,000	4.7
1905	11,951,349,000	2,082,482,000	628,406,000	5.3
1910	14,387,816,000	2,750,667,000	824,241,000	5.7

If we assume that the capital invested both in manufacturing and in railroads is represented by an approximate equal market value of bonds and shares outstanding—which is, perhaps, not far from the truth—then the above figures give us the average rate of yield which the investor in the shares of railroad and of manufacturing companies may reasonably expect.

Although it is not possible to secure exactly corresponding data for other countries, it may be of interest to compare the above percentages with the yields on capital invested in various lines of business in Germany for the year 1908, which were as follows:*

Banking	7.7%
Insurance	19.3%
Chemical Industry	15.7%
Large Scale Chemical Enterprises	11.5%
Mining, Smelting, Salt Works, etc.	9.5%
Textile Industries	9.4%
Electrical Industries	8 %
Street Railways	4.3%

The average profits and dividends for various lines of industries in Russia for 1911 were as follows:†

	Average Profits	Average Dividends
Mining	13.8%	5.5%
Textile	13.5%	5.4%
Credit Institutions.....	15.1%	11 %
Machinery	11.7%	4.4%
Foodstuffs	15 %	6.6%
Commercial Concerns.....	13.1%	7 %
Chemical Industries.....	32.9%	9 %
Insurance	20.6%	12.2%

*"The German Great Banks," by Dr. J. Riesser, reprinted for the National Monetary Commission, Washington, 1911, p. 464.

†"Why Investments Pay in Russia," by Alexander Znamiecke, in *The Americas*, June, 1915.

The reason for the correspondence—or the tendency toward correspondence—in the two factors named above, which at first glance would be regarded as unrelated, is found in the fact that the percentage of net earnings to gross business tends to vary in inverse proportion to stability and in direct proportion to the risk of the business. This sounds like an extremely abstract and difficult proposition, though it is actually simple and practical. A company which is running a street railway system is engaged in a business that is well standardized and is subject to little risk as to fluctuation; consequently, there is a great deal of competition or potential competition among capitalists who are willing to put their money into the business, and the ratio of profits to gross earnings is reduced to a small percentage. On the other hand, the business of manufacturing a novelty which may quickly be displaced is risky, and capital will be invested only by persons who are experienced in the business. For both these reasons, the ratio of profits to earnings or sales must be exceptionally high in order to attract sufficient capital. The same factors precisely are at work in determining how large earnings must be in order to make the shares of various companies command a market price not far removed from their nominal value. The percentage of net profit on sales, and the percentage of yield on investments in the company's shares, will be about the same. Hence, it necessarily follows that capitalization tends to adapt itself and to become equal to gross business. It is perhaps unnecessary to repeat that this is only a tendency and by no means an invariable rule.

Many examples of the adjustment of capitalization to earnings might be cited; indeed, almost any large industrial corporation, the shares of which are widely traded in, would serve this purpose. At its reorganization, the United States Realty and Construction Company had tangible property worth approximately \$11,000,000, and cash amounting to about

\$11,000,000, against which was issued \$27,500,000 in preferred stock and \$33,500,000 in common stock; \$61,000,000 in all. The earning power of the two companies which had been combined amounted, however, to about \$3,500,000, and there was thought to be reasonably good prospects for growth in these earnings. On the strength of these earnings the capitalization was regarded as perhaps somewhat excessive but not abnormal. As a matter of fact, the company later failed disastrously, due in part to the overestimates that had been made of its earning capacity.

A striking example of sudden variation in earnings quickly followed by readjustment of capital is furnished by the Submarine Boat Corporation. This corporation was originally known as the Electric Boat Company, and for many years was regarded as practically a failure. It had an authorized capital of \$5,000,000 common and \$5,000,000 preferred, of which \$4,999,600 common and \$2,667,500 preferred were outstanding. The company's business was to build submarines for which it held valuable patents, and also high-powered gasoline launches which may be used as submarine destroyers. After it appeared that the submarine was to become a highly important factor in the European conflict, it quickly became evident that the Electric Boat Company was in a position to reap enormous profits from the situation. As late as the winter of 1914, the common stock was quoted at a nominal price, around \$10 a share; by the fall of 1915 it had risen to over \$480 a share. During this rise, Isaac L. Rice, the organizer and long the chief manager of the company, sold his shares, which were taken over by a syndicate that arranged to recapitalize and for this purpose formed the Submarine Boat Corporation.

The shares of stock of the new corporation were issued without par value and for this reason it is impossible to cite exact figures showing the extent of the recapitalization.

However, on the basis of the quoted boat shares, the new capitalization of the Submarine Boat Corporation may be figured as having a market value at the beginning of \$35,000,000.

There is surely little doubt in the mind of any one who is familiar with such occurrences, as to the truth of the general statement that capitalization tends very strongly to conform itself to earnings rather than to actual investment.

Estimates of Earning Power

In what has been said in the preceding section as to adapting capitalization to earning power, it has been assumed that there will be no difficulty in determining earnings. If a company has been doing business successfully over a period of years and has had reasonably stable earnings, it would seem that there ought to be little difficulty in estimating the probabilities for the future; yet the experience gained during the last 15 or 20 years in forming combinations of industrial companies indicates quite clearly that even expert estimates are an unsafe guide.

At the time the American Malting Corporation was formed in 1897, a preliminary examination of the 22 plants concerned was made by an accountant of high standing, who reported that these concerns had earned about \$1,300,000 per annum during five years of depression, and that the net earnings under a combination should be at least \$2,000,000 without raising the price of the product to the consumers. Unfortunately, in making this estimate one important factor was overlooked. The business of furnishing malt to brewers had been an affair largely of financial connections and personal friendships. The brewers preferred to deal direct with the heads of the concerns from whom they bought their malt and refused to take kindly to the more businesslike methods of the "trust." As a result, the combination, instead of gaining

through the greater efficiency of its sales methods, actually lost ground. The whole transaction, it has been remarked, is "a startling illustration of the fallacy of basing an estimate of the future earnings of a consolidated company upon the aggregate earnings of the constituent plants prior to their combination."*

In his excellent study, which is frequently referred to in this volume, Mr. Dewing includes a list of important industrial combinations showing the ratio between the earnings actually realized after the consolidation, and the aggregate earnings of the subsidiary companies before the combination. The following are his percentages:

Mount Vernon-Woodberry Cotton Duck Company	166%
National Salt Company.....	134%
New England Cotton Yarn Company.....	98%
International Cotton Mills Corporation.....	56%
United States Ship Building Company.....	56%
United States Realty & Construction Co.....	50%
Asphalt Company of America.....	40%
American Malting Company.....	31%
American Bicycle Company.....	24%

Some of the discrepancies above shown may have been due in part to padded statements of earnings on the part of the companies which just prior to the combination were trying to make the best possible terms for themselves, and some are due, doubtless, to the fact that combinations are generally organized at the height of a period of prosperity. In general, however, they seem to represent a tendency toward actual decline in efficiency under the new form of organization.

Wherever the personal element in management is strong, estimates of future earnings are particularly uncertain. After a strong, going organization has been formed and methods have become standardized, this element of uncertainty due to

*Dewing's "Corporate Promotions and Reorganizations," p. 273.

the personal factor becomes less and less prominent. Nevertheless, in some lines of business it is especially strong. For example, it is reported that bankers are not willing to make large advances to companies engaged in operating chain stores. They believe that these stores depend to an especial degree upon the human equation. A single mistake in buying on a large scale might result in serious loss, for these stores generally sell on a close margin of profit. The death of the executive who had built it up and had formed his personal connections might be a fatal blow.

Another source of uncertainty in lines of business where earnings would otherwise be remarkably stable, consists in the legislating power of governmental bodies. The legislatures of several states have in recent years passed laws fixing rates of transportation and of public utility services on arbitrary bases which have introduced a sudden and wholly unforeseeable change in the earnings of the corporations affected. There is probably no reasonable ground for doubting that this is a wrong principle. Wherever profits require regulation, it should certainly be carried on by some systematic and continuous method. In Great Britain there is no such thing as public rate regulation as understood in America. The two methods of regulation are the maximum dividend method and the sliding scale method, both of which operate continuously and automatically.

There is, perhaps, no safe practical rule to follow in making or in reviewing estimates of future earnings, except to follow the rule of skepticism. Sometimes the skepticism may be undeserved, but at any rate the banker or investor can make no mistake in demanding full and satisfactory evidence of the correctness of the estimates. This remark applies especially to promoters' estimates of the future profits of their concerns. "When you are capitalizing a *perhaps* which you believe to be infinite," says Hartley Withers in one of his incisive

epigrams, "the number of noughts that you add on to the market value of the company's capital is a matter that does not concern you as long as you are wrought up to the right pitch of excitement."*

Adjusting Capitalization to Assets

It is plain, from what has been said above that many corporations, either at the outset or at some later stage in their career, are faced with wide discrepancy between the actual value of all their assets and the nominal net worth of the business which is represented by capital stock. In 1897, for example, the Glucose Sugar Refining Company was organized as a combination of six glucose refineries. Although \$7,500,000, it is reliably estimated, would have fully covered the actual value of the plants and current assets acquired, the company started with a capital stock issue of \$37,000,000. In 1906 this same combination, with some additions, was reorganized under the name of the Corn Products Refining Company, which is estimated to have had assets worth approximately \$15,000,000. Against these assets the company issued a bonded debt of \$9,500,000, preferred stock of \$30,000,000, and common stock of \$50,000,000.

Once in a while, if a corporation has been continually unsuccessful over a period of years, an effort is made to improve the financial status by reducing its capital stock and its contingent charges. This was attempted, for example, with the Corn Products Refining Company in 1910, when the president brought out a plan which called for the absolute surrender and cancellation of four-fifths of the outstanding \$50,000,000 of common stock; the remaining one-fifth of common and all the preferred stock was to be exchanged for new stock of one class, upon which it was proposed to pay dividends at the rate of 5% per year. The result would have been to

*Hartley Withers on "Stocks and Shares," p. 287.

cut down the charges against the company and to make up a much better-looking balance sheet. However, the preferred stockholders saw no advantage to themselves in giving up part of their claims and the plan eventually failed.

A similar process is much more frequent in English practice. In November, 1914, a circular letter was sent out to the preference shareholders of R. White and Sons, in which the directors stated that they had had fresh valuations made of the assets which had disclosed a total value less than the book value of these assets, amounting to £87,760. The directors were also anxious to eliminate from the balance sheet the large "good-will" item which amounted to £94,367, and thought it wise to write off a further sum of £7,500 against other assets. These three sums together amounted to £189,627. The directors' proposal was to charge £25,627 against Reserves and Profit and Loss accounts, leaving £164,000 still to be dealt with. This was offset by reducing the nominal value of all the outstanding ordinary shares from £3 to £1 each. The ordinary shareholders made it a condition of their agreement to this arrangement, that they should be entitled to the same aggregate amount of dividends on their shares as they were previously entitled to before contributions were made to the special reserve. That is to say, where they were previously entitled to 5%, they were, after the change, entitled to 15% on the reduced capitalization.

To the average American mind all the complexities and niceties of a transaction such as the one just described, seem like so much useless juggling with figures. The purpose of any well-managed company is to make profits and distribute them according to the various claims against these profits that are outstanding. Whether the ordinary stock is listed at a nominal value of \$82,000 or \$246,000; whether "good-will" stands at \$94,000 or at nothing, and similar questions of academic accounting, have very little apparent connection with

changing the business from a profit-loser into a profit-maker. The typical English financial manager attaches vastly more importance than does the typical American financial manager, to presenting a balance sheet that makes an impression of stability and conservatism. Doubtless there is much to be said on both sides. It is enough here merely to call attention to the variation in practice.

It is sometimes thought to be desirable by the directors of a corporation to have the corporation purchase some of its own outstanding stock, which is, in effect, a method of reducing its capitalization. The general rule of the law, which applies with modifications in almost all jurisdictions, is to the effect that a corporation may purchase its own shares only out of surplus. It cannot, in other words, carry the purchase of its own shares so far as to produce a deficit which might be injurious to creditors.

Valuation of Good-will

The law assumes that the assets of a corporation are valued at cost and that, after the deduction of liabilities, the remaining equity in the assets is represented by capital stock.

The truth of the case is, as we have seen, that capitalization—at least for the companies with marketable securities—is determined on the basis of earning power, and that the book valuation of a company's assets is then adjusted to the capitalization. This makes the valuation of assets for accounting purposes, in part at least, an arbitrary process. Whenever it is not thought desirable to place a purely arbitrary value upon tangible assets, or whenever the capitalization is so large that any arbitrary value within reason will still leave a gap, then we have "Patents," "Copyrights," "Organization," "Good-will," or some other intangible asset entered upon the books and appearing in the balance sheet at a valuation sufficient to offset the nominal value of outstanding capital stock.

As an illustration, take a case, which came to the writer's attention some years ago, of a company publishing a well-known popular magazine, which had issued stock only for an equivalent amount of cash paid in. The magazine had outstanding \$300,000 of common stock; had assets over and above the liabilities (except stock) of approximately \$250,000; and showed also on the asset side of the balance sheet an accumulated deficit of practically \$50,000. Its balance sheet in this highly condensed and simplified form would appear as follows:

<i>Assets</i>		<i>Liabilities</i>	
Net Capital and Current		Capital Stock.....	\$300,000.00
Assets	\$250,000.00		
Accumulated Deficit....	50,000.00		
Total	<u>\$300,000.00</u>		<u>\$300,000.00</u>

Just about the time when the magazine had reached this stage and its proprietors were greatly discouraged, it started to run a series of feature articles which suddenly became immensely popular. The circulation and advertising receipts suddenly jumped to figures previously unthought of. In the first year after this sudden change of fortune, the corporation earned profits of approximately \$40,000, and the directors desired to distribute dividends of \$30,000. But there was no surplus out of which to declare dividends; on the contrary, the balance sheet still showed an impairment of capital which must be made up before dividends could legally be declared. In this predicament they called in an experienced accountant who solved the difficulty by directing that a very simple entry be put into the company's journal, debiting a new account to be called "Good-will" to the amount of \$100,000 and crediting Surplus for a like amount. Thereafter the company's balance sheet in its highly simplified form, appeared as follows:

<i>Assets</i>		<i>Liabilities</i>	
Net Capital and Current		Capital Stock.....	\$300,000.00
Assets	\$290,000.00	Surplus	90,000.00
Good-will	100,000.00		
Total	<u>\$390,000.00</u>		<u>\$390,000.00</u>

There was then nothing to prevent the immediate distribution of cash profits in the form of dividends.*

Good-will is not necessarily valued in quite so arbitrary and casual a fashion. Where a corporation has accumulated out of earnings a substantial surplus, and where there is genuine good-will which it is desirable to show in one form or another in the balance sheet, a careful valuation may be made. For example, a case of this nature arose in connection with the appraisal in September, 1914, of the estate of the late Joseph Pulitzer, former proprietor of the *New York World* and of the *St. Louis Post-Despatch*. The appraiser, first of all, made a careful estimate of the earning power of each one of the newspaper properties. For this purpose he took the average annual earnings of each corporation for four years preceding Mr. Pulitzer's death. From this average figure, however, he deducted a considerable sum by reason of certain very favorable contracts for the purchase of white print paper which were about to expire, and he further deducted \$100,000 as being a reasonable estimate of the value of the services of Mr. Pulitzer himself. He deducted, also, 6% on the actual capital invested. This left average net earnings of \$196,411 for the *St. Louis Post-Despatch*, and \$81,180 for the *New York World*, both of which the appraiser capitalized on a 10% basis, making his valuation of the good-will of the first-named paper \$1,964,110, and of the second-named paper, \$811,800.

*The case just cited is actual but the figures have been much changed in order to simplify the statement and to avoid identification.

The above case is one of the most important precedents for methods of valuing good-will that have been established in this country. In England it is customary to calculate the good-will as the present worth of the profits from three to ten years ahead, the length of time depending upon the stability and transferability of the business.

The following remarks on this point were made by the writer in connection with an inquiry as to how to determine the value of an insurance agency business:

Having arrived at the value of all the other assets of an insurance agency, i.e., furniture and fixtures, insurance in force, real estate, etc., it would then be necessary to estimate the worth of its insurance business itself. The personal equation plays a great share in agency insurance, and the withdrawal of the man or men who have been actively identified with the establishment and with the running of the agency is likely to affect seriously the earnings of the concern, especially if the business has been confined to a particular locality, which is often the case. There is also to be considered the value which attaches to its sub-agency force as well as the volume of business the agency is doing, since the rates of commission paid by the insurance companies and the credits extended by them in the collection of premiums are by no means uniform. An additional point to be considered is that in many instances insurance agents also act in the capacity of adjusters in fixing losses of their clients. The earnings from this source are often not to be found on the books of insurance agents, and it is an item to be considered.

Having in mind all these factors, the test to be applied in determining the worth of the business itself is: How much earning power could be transferred to other individuals who might take over the business? Capitalize this earning power at whatever rate is agreed upon, say 15%, and you have the transferable good-will of the business.

In this discussion, no attempt has so far been made to give an accurate definition of the vague term "good-will." It is, in fact, almost incapable of definition for the reason that it is continually used in many varying senses. The term arose undoubtedly in connection with retail trade and with professional practice, where it referred to the habit that had been established on the part of many people who were accustomed to trading with a good shop or with an established professional practitioner. Experience has shown that this habit will continue to carry people to a shop or to a physician's or lawyer's office even after the original proprietor or practitioner has withdrawn. The vendor of a business or a practice of this nature usually contracted, for a given consideration, to recommend his successor and thus literally sold to him his "good-will." As it is used in a great majority of present-day transactions, the term has little perceptible relation to its original meaning.*

When a modern corporation transfers good-will or enters good-will upon its books, the asset which is thus represented consists of something even more intangible than the kind of good-will that accompanied the sale of the little retail shop. A corporation's "good-will" may consist in part of established trade and of the habits of people who desire to buy its products; it may consist in part of having created an efficient, smoothly working internal organization; it may consist in part of having driven off all rivals and monopolized its field; it may consist in part of well-known trade-marks or of patents. An adequate definition of "good-will" in its modern sense must cover all the above and many other similar variations of intangible assets. The one definition which seems to the writer to cover everything is this: Good-will is the capi-

*The classical definition of good-will, according to Withers, was contributed by Dr. Johnson, when, as executor of a friend's estate, he assisted at the sale of a brewery to two Quaker gentlemen. Being asked to place a value on the real assets, he replied: "We are not here to sell a parcel of boilers or vats, but the potentiality of growing rich beyond the dreams of avarice."

talization of that portion of the earning power of a business which is not credited to other assets.

With this definition in mind, the question as to the right method of valuation of "good-will" in any given case is simplified. It is necessary to follow the same method that was used by the appraiser of the Pulitzer properties, that is, to eliminate from average earnings those which are to be ascribed to the ownership of tangible assets or to temporary causes; the remaining earning power may then be capitalized on whatever basis is suitable for the business under consideration. In some lines of business this percentage might be as low as 6 or 8%; in others 10%, and in others 12, 15, and even 20%.

The definition just suggested carries with it a ready explanation of the fact that "good-will" is a much more permanent asset in some lines of business than in others. Those lines of business which employ an overwhelming proportion of fixed capital assets, ordinarily attribute their earnings almost wholly to these assets, and there is seldom any occasion for entering such an item as good-will. On the other hand, those corporations that are engaged chiefly in trading, their earnings being dependent to a great extent upon the rapidity of their turnover or upon popular favor, may find, if they are successful, that their earnings mount far beyond any sum that can reasonably be attributed to their capital assets.

In this latter class belong such concerns as the F. W. Woolworth Company, with its great chain of 5 and 10-cent stores, which carries a Good-will account of \$50,000,000. Many publishing companies quite properly carry good-will as one of their most important assets. The Butterick Company, out of total assets of \$19,236,467, has \$9,786,065, or over one-half, included under the heading "Patents, Good-will, Contracts, Copyrights, Trade-marks, etc." Messrs. Silver-Burdett and Company carry "Publishing Rights, Contracts, Copyrights, etc.," at \$1,024,820 out of total assets of \$1,944,665.

There are many cases, also, where highly profitable and rapidly growing companies may have trouble in valuing their assets at a figure high enough to offset the amount of stock which their directors feel should properly be outstanding. This is the case, for instance, with the Hendee Manufacturing Company of Springfield, Mass., which on August 31, 1914, carried a Good-will account of \$8,300,000 out of total assets of \$13,367,502. The American Chicle Company carries "Good-will, Trade-marks, etc.," at \$8,128,607 out of total assets of \$13,592,997. In spite of this enlarged capitalization, the company has paid 18% dividends on its common stock regularly since 1907. On the other hand, the highly successful and long-established Eastman Kodak Company, which is paying dividends that average over 40%, and is earning in the neighborhood of 70% on common stock, does not carry a cent of good-will or other intangible asset accounts.

Recapitalization by Stock Dividends

In cases where surplus has accumulated with great rapidity, it is more and more customary for the corporation to recognize this accumulation by issuing new shares in the form of stock dividends. As has been previously explained, this procedure does not necessarily mean increased cash returns to the stockholders and does not affect their relative interests in the corporation, but it is convenient and helps to increase the market value of the stock. In recent years, some of the motor companies which have been highly successful have declared notable stock dividends. The Chalmers Company, for example, was incorporated in 1908 with a capital stock of \$300,000; two years later the directors declared a stock dividend of 900%, making the capital stock \$3,000,000. In October, 1912, they declared another stock dividend of 33 1/3 %, making the outstanding common stock \$4,000,000; and in June, 1913, another dividend of 25% was declared, making the outstand-

ing stock \$5,000,000. Since June 1, 1911, cash dividends on the common stock have been paid at the rate of 10%. In 1915 the Ford Motor Company was said to have had under consideration a stock dividend of 2400%, increasing its outstanding capital stock from \$2,000,000 to \$50,000,000, but on account of some legal difficulties the plan, up to this writing, has not been carried through.

Other manufacturing companies have also had remarkable stock dividend records. Up to 1900 the capital stock of the Singer Manufacturing Company was \$10,000,000, and that year a stock dividend of 200% was declared, making it \$30,000,000. In 1910 another stock dividend of 100% was declared, making the capital \$60,000,000. During all this period cash dividends have been high. In 1899, just before the first-named stock dividend, cash dividends were 100%; in 1904 and again in 1909 they were as high as 30%; since the stock advance of 1910 they have been averaging 12 to 14%. Swift and Company originally had a nominal capital of \$300,000, which has been increased at various times to \$3,000,000, \$5,000,000, \$7,500,000, \$15,000,000, \$20,000,000, \$25,000,000, \$35,000,000, \$50,000,000, \$60,000,000, and finally \$75,000,000.

Attention has already been called to the possibility of avoiding constant changes in capitalization—which are always of an arbitrary nature—by the use of shares without par value. It would be theoretically possible to have no shares whatever outstanding, and there is one case on record of an English enterprise known as the Undertakers of the Aire and Calder Navigation and Steamship Company, which until 1895 had no shares. The capital was bought and sold at so many years' purchase of the dividends. The modern arrangement, however, is to have shares bearing no par value. A law authorizing the issue of shares without par value was adopted in New York State in 1912.

Capitalization of Public Service Companies

The assumption which has been made throughout this chapter that capitalization may be rightfully adjusted to whatever figure within reason the organizers or directors of a corporation may think proper, applies to manufacturing and trading companies, but does not apply to financial companies or to most public utility companies. Financial companies are in this respect in a class by themselves, for the reason that they are themselves dealers in cash and in credit and it is essential that their financial position should be at all times clear and easily ascertainable; consequently, they do not enter good-will on their accounts, not because it does not frequently exist, but because to do so would involve questions of judgment and of motive which they cannot afford to have raised. For that reason their balance sheets ordinarily show only assets the value of which can readily be determined by examination, and as to which no debatable question is likely to arise.

The case with public utility companies differs because of public sentiment which has been aroused against "overcapitalization," which is believed by many people to be injurious. In this respect the English practice is even more severe than in this country. The policy of Parliament and also of the Board of Trade of the United Kingdom has been to grant power to railway and tramway companies to raise an amount of capital estimated to be sufficient for their immediate requirements; in granting capital powers to gas companies, the Board of Trade usually endeavors to estimate the requirements of the company for a term of 12 to 15 years. It is clear that the intention is to maintain a strict governmental control and to see to it that every cent of capital is represented by a corresponding amount of cash or of assets purchased with the shareholders' cash. In the United States, public service commissions are following much the same policy. In

New York State the output of stocks and bonds by utility corporations is carefully regulated to such an extent that it has proved really a difficult matter in some instances to secure permission to obtain capital that was urgently needed. For some years there has been agitation to apply the same principles of regulation to interstate railroads, but no definite action has as yet been taken.

We may conclude, then, that in general the capitalization of public utility companies is more strictly in accord with the legal theory of a correspondence between capitalization and capital assets than is true in other forms of enterprise. Public utility companies are among the enterprises above referred to, the earnings of which can generally be attributed almost wholly to their tangible assets. As a practical matter, therefore, it is not inconsistent with the practice of most of the well-managed companies to require that they should issue capital stock only for the purpose of acquiring cash or tangible assets fully equivalent to the nominal value of the stock.

Part III—Securing Capital

CHAPTER IX

SOURCES OF CAPITAL FUNDS

Capital Funds

The typical corporation starts in much the same way as the typical partnership—through an agreement on the part of two or more men who are acquainted with each other, to join forces in a business enterprise. In a partnership, these men sign a formal partnership agreement and pool part or all of their capital and other resources; in a corporation they mutually agree upon the amount of capital required, the amount of capital stock to be authorized, and the issuance of the stock for cash, property, and services. No matter which financial form is adopted, the essential fact common to both is that the money and the business ability required for the enterprise are both supplied by the same group of men.

As the corporation expands—assuming that it is a success—and fresh capital is needed, it may come in whole or in part from the same group of men. In case their capital has been exhausted or is otherwise tied up, the next move, frequently, is to find some other man who has capital to invest and at the same time will be a valuable addition to the executive staff of the business. Some concerns keep on growing in this way for a long time. Other concerns—by far the vast majority—soon attain their normal volume of business and thereafter need little if any fresh capital. In both these cases, the source of capital plainly is the man or group of men who are themselves active in the management of the business.

A second source of capital, which usually operates in connection with the source just named, consists of savings out of the profits of the business. Practically every concern saves and adds to its permanent capital a portion of its profits. In corporations which are owned by the people active in the business, the tendency is strong toward putting a large proportion of the profits back into the business. The active men realize the needs and the possibilities in the business better than outside stockholders could possibly do. Sometimes they are willing to put back practically all the profits and to keep up this policy over a period of years. The enormous capital of the Carnegie Steel Company was, for example, almost wholly built up by this method. Much the same thing is true of the Winchester Arms Repeating Company and of many other closely held and highly successful concerns. A conspicuous recent example of the great results which may be achieved by the patient saving and reinvesting of good profits over a series of years, is the Bethlehem Steel Corporation.

Most companies that are successful on a large scale reach the point, in the course of a few years, where more capital is needed than can possibly be supplied by the people who are directly engaged in handling the business. Some corporations, as we shall see, reach this stage at the very beginning; that is to say, they start full blown as publicly owned enterprises. They are, however, exceptional. Whenever it is necessary to go outside the group of men who are directly connected or directly familiar with the enterprise, the capital may be said to be raised from the public at large. For our purpose we may divide this public—as is customarily done in nearly all writing or thinking on financial subjects—into two fairly distinct groups—those who invest and those who speculate. The investing public consists of the people who are more concerned over getting back their principal than they are over making profits. The speculative public consists of those who

are chiefly concerned in making profits, and for this purpose are willing to accept more or less risk with the principal. It has previously been noted that distinct types of security issues are designed to appeal to these two groups. There is, of course, no sharp dividing line.

So far as the issuance of securities is concerned, there is little to be said at this point in connection with the first and second sources of funds named above—persons close to the business and the profits of the business. Some attention must be given, however, to the forms of securities that should be selected if an appeal is to be made to the third source, the investing public, or to the fourth source, the speculative public.

The Investing Public

The word "public" suggests a large crowd of individuals, and the term "investing public" may easily call up a vivid picture of thousands of staid and prosperous persons who personally tuck away their own bonds in their strong boxes and whose chief labor consists in cutting off the coupons. This picture is to a certain degree true of the purchasers of those investments which have a slightly speculative tinge, such as bonds that sell on a basis of $5\frac{1}{2}\%$ or more. John Moody, however, is authority for the statement that the "gilt-edge" investment securities are taken chiefly, not by individuals, but by institutions. These securities sell on the basis of, say, 3% to $5\frac{1}{2}\%$, and the individual investor is much more apt to be a contributor in some way to the support of these large investing institutions, rather than a direct purchaser of this type of securities.

Banks and Institutions

First among the institutional investors, we find banks. Savings banks are enormous purchasers of the highest grade bonds. Under the laws of most states their purchases are

clearly restricted to bonds of a certain approved class which are frequently referred to in Wall Street as "savings bank bonds." Commercial banks, also, from time to time take large quantities of investment securities, chiefly short-term obligations. Insurance companies spend a vast amount annually in the purchase of investment securities. All institutions the funds of which are held in trust, such as universities, philanthropic institutions, and the like, must confine themselves strictly to investment securities. Estates of deceased persons, administered in trust, are large purchasers.

Institutions, then, constitute the public to which the highest grade investment securities must be sold. Individuals handling their own funds are free to exercise their discretion and take whatever slight degree of risk there may be in the purchase of securities that do not comply with the strict terms of the laws covering institutional investment.

It will be readily seen that there are noteworthy advantages to the corporation which can adapt any important part of its securities to the requirements of institutional investment. First of all, such securities are in high demand and sell at excellent prices. Second, they are likely to "stay put" after they are sold. The institution ordinarily does not die or become hard up or easily panic-stricken; consequently, securities which it has once purchased are likely to remain with it until they mature. Throughout the crisis in the affairs of the New Haven Railroad Company in 1913-1914, the debentures of the company, which were closely held by insurance companies and savings banks, did not to any great extent come on the market.

Investment Associations

In other countries even those individual investors who in this country would buy securities direct are apt to efface themselves as individuals and join investment trusts or investment associations. These associations are common in Great Britain,

France, and Holland, and are not uncommon in other countries. The investment associations frequently sell their own bonds as well as their own shares. They take the money thus obtained and invest it in securities of other corporations. What is the advantage, it may be asked, of this indirect method of investing?

The great advantage is that the uninformed judgment of the individual who purchases only a few stray securities from time to time, is replaced by the trained and experienced judgment of men well acquainted with investment securities and the investment market. This at least is the theory of the situation. There is another advantage, also, in the fact that, instead of having available for investment only the small savings of individuals, the investment association deals in large sums and is therefore in a position to buy advantageously. Furthermore, on account of its large purchases it can distribute its risk over a wide field. Its securities, for instance, would not all be bought in one country but in several countries; they would not all be in one or two lines of business, but in several lines, and so on. This principle of the distribution of risk is the most practical form of insuring the safety of the investment that has yet been brought forth. The investment associations, as a rule, are managed with skill and ability and in the long run make money; though there are, of course, some unfortunate exceptions.

Speculative Public

The purchasers of speculative or even semi-investment securities are, with negligible exceptions, individuals. The term "semi-investment" in this connection is applied to such securities as high-grade preferred stocks and junior bonds, which are customarily regarded as reasonably safe but which are subject to a greater degree of fluctuation and uncertainty than the strictly high-grade investments. There is a fairly

clear three-fold division of the immense number of purchasers and possible purchasers of speculative and semi-investment securities:

1. The buyers who have in view primarily the safety of their principal, in which they do not anticipate any great appreciation in value, but who desire a larger rate of return than can be obtained from strictly investment securities. These are the purchasers of junior bonds, preferred shares, and the like.

2. The purchasers who are looking primarily for an increase in the value of their principal, though they do not object, naturally, to a high percentage of yield. These are the purchasers of common shares, especially those which are not so thoroughly seasoned as to approach the semi-investment grade of securities. The members of this group are likely to be for the most part people who have some especial connection with, or interest in, the corporation, the shares of which they are purchasing; often they are minor officers or employees of the corporation.

3. The speculators on margin, who operate on the Wall Street and other stock exchanges. A large number of them are merely gambling; others have some special information as to a given corporation the shares of which are listed on the stock exchange, and are trying to make capital out of their information. Still others are observers of general market conditions, and buy and sell standard issues with little regard to their intrinsic value, but with a great deal of regard for the buying and selling movements on the exchange which they see in progress.

Some of the details in this rough outline sketch will be filled in later when studying methods of selling security issues.

Wide Distribution of Shares

A remarkable feature of the last ten or fifteen years in the United States has been the widening distribution of the shares

of large corporations, indicating that a greater and greater number of people who possess or can save capital are putting their money into corporate securities. Taken in the aggregate, the size of the speculative public in the United States is enormous. The *Wall Street Journal* calculates that 327 large corporations in 1913 had a total of 1,251,468 shareholders listed on their books. Even after making a liberal allowance for duplications, the number is strikingly large. Many of the stockholders are small. The 327 corporations analyzed have a combined share capital of \$12,871,327,450. The average holding of railroad shares is \$13,320; of industrial shares, \$8,500. For industrial shares the average holdings in recent years are as follows:

1901, \$22,000	1911, \$10,000
1906, 14,000	1913, 8,500

The United States Steel Corporation has over 124,000 shareholders of record, among whom are included many foreign investment associations and other holders who are practically trustees for a considerable number of other people, so that the total number of persons financially interested in the United States Steel shares is thought to be about 150,000 to 160,000; 40,000 of the shareholders are its own employees and they constitute about one-sixth of the total number of employees of the corporation. In 1901 the average holding of United States Steel shares was \$32,000; in 1906, \$15,000; in 1913, \$7,000. The average holdings of other important companies compare as follows:

	1901	1913
American Telephone & Telegraph Co.	\$14,105	\$6,400
American Radiator Company	30,800	8,700
American Tobacco Company	33,700	14,185
Burroughs Adding Machine Company	24,000	24,000
Borden's Condensed Milk Company	367,646	10,630
General Electric Company	6,900	7,400
United Fruit Company	7,500	4,842

It is clear from all these facts, that the most successful and most popular corporations are carefully cultivating the good-will of the owners of small amounts of capital, including their own employees, and that a notable transfer of ownership into the hands of a larger number of people is in process. This does not, for the present, necessarily mean a transfer of control, which is usually safely in the hands of a few large holders of shares. Yet it involves some tendency at least toward corporate democracy, both in the ownership and in the control of large corporations.

Selling Shares of Smaller Corporations

From this same source, the speculative public, must come the capital of small enterprises. After an enterprise has passed the stage in which the capital is furnished by those directly engaged in the enterprise, if the business itself is worthy and sufficiently profitable, there is no good reason why it should ever fail from lack of sufficient capital. The difficulty in most instances where needed capital is not obtained, consists in the very common delusion that the capital is to be sought far away from home. When one of the enormous, nationally known corporations, with years or perhaps generations of success behind it, desires to obtain some millions of dollars of fresh capital, its officers enter into a contract with some banking firm which undertakes to furnish the capital and which in turn disposes of the securities of the corporation among its own clientele. This is the big-scale method of raising fresh capital from the speculative public. The actual work of selling the corporate stock is not performed by the corporation's officers. All that they need to do is to make the right kind of contract. Often the manager of a small local corporation forms the idea that he should and can raise his capital in the same impersonal way. He altogether forgets that his neighbor Jones has just sold a farm and has \$10,000 lying idle in the

bank; that his customer Smith is a good personal friend of his and can raise any reasonable amount of money; that his employee Brown is building up a good-sized savings account and would save more and work better if he were stimulated by the pride of owning an interest in his employer's business. Instead of interviewing Jones, Smith, and Brown, with money in their pockets which they would willingly exchange for shares in his enterprise, the corporate manager of the type we have in mind is apt to think that some broker in a distant city could easily raise the \$10,000 or \$50,000 that is needed if he could only be persuaded to undertake the job.

The best place to start in looking for purchasers of speculative or semi-investment securities of a small corporation is among business acquaintances of the men who are already interested in the corporation. After a few of these acquaintances have themselves become shareholders, they will cooperate in reaching other people, and so the list of prospective purchasers of the securities will expand in an ever-widening circle until the whole amount of the capital required has been raised. The best person to whom to turn for advice, ordinarily, is the most progressive banker in the community or—if it is a large city—the bankers best acquainted with the trade in which the corporation is engaged. It is the banker's business to know the financial standing of his customers. If he is willing to say a good word for the enterprise, it will go a long way. At any rate his advice will be worth having. It may be safely said that any corporation which has a really attractive offer to make to the stock-buying public need not apply in vain.

Adaptation of Securities to Market

In previous chapters the principal forms of security issues—common and ordinary shares, preferred shares, income bonds, debentures, collateral trust bonds, mortgage bonds, and

the like—have been described. The point has been emphasized that, while there are favored and popular forms of security issues, there are no invariable forms. Some kind of a security issue can be found that will suit both the taste and the pocketbook of anyone who has capital at his disposal. The financial manager of a business enterprise will make it his business to make such adaptations of the securities he has to offer as will best fit them for the market he is trying to reach. If his prospective purchasers are people of small income, he may find it best to issue shares of a par value of \$5 or \$10, instead of the conventional \$100. At the other end of the scale, if he is getting out a note issue exclusively for sale to some of the big institutions, he will perhaps give his notes a par value of \$10,000 or even \$100,000. He will give reasonable attention, also, to passing fashions or popular interests. In one year convertible bonds are much talked about and easily sold. In another year the popular interest is centered largely on industrial preferred shares. In another year there is an unreasoning aversion, let us say, to collateral trust bonds. Any successful dealer in securities will advise that these fashions and whims on the part of the investing public be not ignored.

In choosing forms of securities, unfamiliar financial devices are not usually favored unless they are brought forward by some individual or corporation with great prestige. The financial conditions at the time when the security is brought out must also be carefully considered. It has previously been suggested that short-term notes have been issued by railroad and other corporations in the United States in great quantities during recent years, partly because there is a public preference for such notes and partly also because it has been hoped from year to year that the world-wide financial depression would give way to a better market for long-term issues. The wisdom or unwisdom of this course

need not be here considered. The point to be made here is that the large corporations have been consciously endeavoring to adjust their security issues to current conditions in the security market.

A striking example of very poor judgment in failing to make this adjustment is to be found in the history of the ill-fated Cordage combination. In April, 1893, the National Cordage Company had an inventory consisting of between \$5,000,000 and \$6,000,000 of binder twine, against which it had borrowed more than \$5,000,000 from New York and Boston banks. While it was in this critical condition the crisis of 1893 became more and more threatening and some of the bankers notified the company that their loans must be at least in part repaid on maturity. On Friday, April, 28, 1893, the shares of the National Cordage Company were selling at excellent prices, the preferred at 103¾ and the common at 61, and the credit of the company was high. The following morning at a special meeting of the board, it was decided to take care of the demands of the banks by an immediate offer to the common shareholders of \$2,500,000 of new preferred shares at par. This was equivalent to giving the common shareholders a privileged subscription of some slight value. Under ordinary conditions there would have been little doubt as to the success of this move. But the conditions were not ordinary. The action of the board was interpreted in the light of the general feeling of suspicion and uncertainty as to the soundness of all corporations. On the following Monday a bear party attacked the National Cordage Company's shares and the market price of the common fell below 50; two days later it had gone down to 36. Under these conditions it was, of course, out of the question to make a success out of the preferred stock issue. The banks became alarmed and demanded immediate and full repayment and the company suddenly collapsed. It was one of

the most surprising and spectacular insolvencies that is to be found in the financial history of the country.*

Every possible measure should be taken to meet the convenience of prospective purchasers in putting out bond issues of large corporations which enjoy an international market; for example, it is customary and proper to make interest payable at the principal cities of the various countries in which the bonds are likely to be sold. There are a number of issues of this country the interest on which may be collected in Paris, London, Berlin, or New York.

Earnings and Security Issues

Up to the present point in this chapter we have considered only the relations between security issues and the needs or notions of the prospective purchaser of these issues. It is, of course, clear that there must be a correspondence also between the security issues and the needs of the corporation. The mere fact that a security of a given type is thought to be easily salable is not the final reason for issuing just that security. The corporation's interests may best be served by some other type of security, and it may be necessary—in fact, generally is necessary—to make a compromise.

From the corporation's standpoint, the outstanding securities should be in correct relation both to the assets of the corporation and to its earnings. If this correct relation—or an approximation to it—is not secured, then one of two undesirable results must follow: either the capital required is secured upon terms that are more or less onerous and wasteful, or, on the other hand, the corporation is burdened with claims which it may not be able to meet and which, therefore, en-

*Undoubtedly the National Cordage Company was in unsound financial condition, but it need not necessarily have gone down just at this time if it had not been for the imprudence of the directorate in failing to give due consideration to the general market conditions. It seems probable that their action was hasty and taken without proper financial advice. (See remarks in Dewing's "Corporate Promotions and Reorganizations.")

danger its continued existence. The first-named fault is probably both less frequent and less to be condemned than the second fault.

Some conspicuous examples of wastefulness in raising corporate capital may readily be picked out. The Singer Sewing Machine Company, although it possesses tangible assets of enormous value, has no bonds or preferred shares outstanding, but only its \$60,000,000 of common shares. The same thing is true of the Pullman Company which has only its one issue of \$20,000,000 common outstanding; the Mergenthaler Linotype Company with its one issue of \$12,786,700 common stock; and the Arlington Mills with \$6,000,000 in common stock. All these corporations could sell with reasonable safety—and during many years in the past could have sold—bond or preferred share issues by means of which capital could be raised at a rate considerably less than through the issue of common shares. All these corporations, it is true, are exceptionally prosperous; their shareholders are well satisfied and perhaps would prefer the complete safety of their present position to the qualified safety which they would enjoy if prior claims ranked ahead of them. Nevertheless, it is true that earnings on the common shares would no doubt be considerably higher if the required capital had been obtained in part through bond and preferred share issues. The truth of the case is that the assets of all these corporations have been accumulated chiefly out of surplus earnings and the profits have been so large that there has been no occasion to depend upon security issues to any great extent for fresh capital. The objection that is here raised to their present arrangement of security issues is, therefore, it may be freely granted, of an academic nature. If these and other prosperous corporations which have relied wholly on common stock issues have erred at all, it has clearly been on the side of conservatism and safety.

Effect of Limitation to Common Stock

There are other corporations, however, the business of which is not profitable to so remarkable an extent, and which have actually caused unnecessary sacrifices to their stockholders by reason of a blind adherence to the policy of putting out only common stock. If a public utility company, for example, were to attempt to finance itself solely by the sale of common stock, the chances are that there would be very little money for anyone interested. The profits on such enterprises are comparatively limited, and the financing must be watched with the closest attention in order to preserve reasonably good earnings for the benefit of the common shares. This can be made clearer by a hypothetical case than by any example which is at hand, for practically all public utility companies do raise the greater portion of their capital through issuing obligations rather than through issuing shares. Let us suppose that a public utility corporation requires \$10,000,000 capital, and that its net earnings amount to \$600,000, or 6% on the invested capital. Clearly this would not in itself be an attractive return to prospective purchasers of the common stock. Let us further assume, however, that \$6,000,000 of the required capital is secured by bond issues at an average cost to the corporation of 5%; that \$2,000,000 is obtained through preferred stock or junior bond issues at an average cost to the corporation of 6%; and that \$2,000,000 consists of common stock. In that case, the annual profits would be distributed as follows:

Bonds,	\$6,000,000 @ 5%.....	\$300,000
Junior bonds,	2,000,000 @ 6%.....	120,000
Common stock,	2,000,000 with earnings of 9%..	180,000
Total earnings.....		\$600,000

As a matter of fact, it is customary to provide all the cost of the tangible property of public service enterprises by issu-

ing bonds up to about 75% of the cost, and preferred stock up to about 25%. The common stock in this case represents intangible assets and is secured by the promoters of the enterprise as their profits. If this rule were followed in the case just cited, the results would be as follows:

\$7,500,000 bonds @ 5%	\$375,000
\$2,500,000 bonds @ 6%	150,000
Available as earnings on common stock	75,000

Total\$600,000

Some interesting comparisons may be made among the railroad corporations of the United States in respect to the percentage of capital represented by means of bonded obligations as compared with the capital raised through stock issues. Following is a list of some of the important railroads showing their capitalization in stock and in bonds per mile, and the percentage of each form of security.*

	Per Mile		Per Cent per Mile	
	Stock	Bonds	Stock	Bonds
Wheeling & Lake Erie.....	\$80,567	\$77,677	51	49
Erie	78,100	110,847	41	59
Norfolk & Western.....	64,224	54,835	54	46
New York Central.....	60,075	104,222	37	63
Baltimore & Ohio.....	47,413	89,892	35	65
Toledo, St. Louis & Western.....	44,346	65,177	41	59
Union Pacific.....	42,364	43,971	49	51
Lehigh Valley.....	42,089	66,556	39	61
Northern Pacific.....	39,209	30,789	56	44
Chicago & Alton.....	38,679	83,136	32	68
Wabash	36,739	49,381	43	57
Denver & Rio Grande.....	33,984	51,801	40	60
Great Northern.....	29,687	18,440	62	38
Atchison	28,418	28,712	50	50
Chesapeake & Ohio.....	26,768	74,963	26	74
Southern Pacific.....	26,162	60,669	30	70
C., C., C. & St. Louis.....	26,094	43,904	37	63
Southern Railway.....	25,574	40,396	39	61
Illinois Central.....	25,013	41,363	38	62

*Copied from the *New York Annalist*, June 21, 1915.

	Per Mile		Per Cent per Mile	
	Stock	Bonds	Stock	Bonds
St. Paul.....	24,042	34,418	41	59
St. Louis South.....	22,647	30,834	42	58
Seaboard Air Line.....	20,271	36,244	36	64
Chicago & Eastern Illinois.....	20,135	58,072	26	74
Missouri, Kansas & Texas.....	19,955	36,808	35	65
Boston & Maine.....	18,941	30,000	39	61
Northwestern	18,896	27,141	41	59
Atlantic Coast Line.....	14,800	33,345	31	69
Louisville & Nashville.....	14,586	38,376	28	72
Minneapolis & St. Louis.....	12,933	27,070	32	68
Pere Marquette.....	12,263	24,406	26	74
Burlington	12,127	23,504	34	66
Missouri Pacific.....	11,428	41,875	21	79
C. R. I. & Pacific.....	10,126	36,604	20	80
Frisco	9,505	55,734	15	85
Cincinnati, Hamilton & Dayton....	8,127	70,819	10	90

The above table contains some striking illustrations of the second and more serious of the two faults above named. Note especially the high percentages of bonds in the case of roads which are at this writing in the hands of receivers, including the Cincinnati, Hamilton and Dayton; the Chicago and Eastern Illinois; the Pere Marquette; Frisco; Chicago, Rock Island and Pacific; and Missouri Pacific. On the other hand, the sound roads, such as the Pennsylvania and the Great Northern, are, if anything, overconservative in their issue of bonds. Union Pacific, Atchison, Norfolk and Western, Reading, etc., show a proportion of approximately 50% bonds and 50% stock, which may fairly be regarded as conservative and about correct. Of course, the above percentages are suggestive only and might lead, if taken wholly at their face value, to strikingly wrong conclusions. For example, the Wheeling and Lake Erie, which is notoriously unsound financially, shows a proportion of less than 50% bonds out of its total capitalization; but this is to be accounted for, not by conservatism in issuing bonds, but by reckless overissues of stock.

Adequate Income for Common Stock Dividends

It would be useless to give illustrations at this point of corporations which have transgressed the limits of prudence in selling their own obligations to the public, for we shall be dealing with such cases in the later chapters, where financial embarrassments, insolvencies, and reorganizations are discussed. It is obvious, on the face of it, that a corporation, like an individual, may abuse its credit. The rule of safety in the issuance of funded obligations requires that the corporate income shall *at its minimum* more than cover the fixed charges, including both interest payments and sinking fund payments if any. The rule of prudence, which should be regarded invariably in connection with the contingent charges assumed when deferred shares or income bonds are issued, is that the corporate income over and above all fixed charges must be ample, under all conditions that can reasonably be anticipated, to cover these contingent charges. The rule of good faith in connection with the issuance and sale of common stock should be that the anticipated income, based upon the probabilities, should be ample to provide in addition to all fixed and contingent charges a reasonable and increasing return on the common shares. We may state this relation in tabular form as follows:

1. Assured income should be more than enough for fixed charges.
2. Additional income anticipated beyond reasonable doubt, should be more than enough to cover contingent charges.
3. Additional probable income should be more than enough to provide a satisfactory yield on common shares.

It is true, of course, that unforeseen occurrences frequently wreck even the soundest and most careful estimates, and

that the organizers and financial managers of corporations are not always entitled to severe censure because their plans miscarry. They are clearly entitled to censure, however, if they do not make their estimate of future income with reasonable foresight and conservatism, and if, after having procured sound estimates, they fail to observe the relations above referred to between earnings and security issues.

Assets and Security Issues

The assets of every business enterprise fall into three natural divisions:

1. Fixed tangible assets, which are essential to the proper conduct of the business.
2. Current assets, which consist of cash and of such property as can readily be converted into cash.
3. Intangible assets, which have previously been defined as the capitalization of the earning power which cannot be attributed to the other assets.

There is a relation between these classes of assets and the security issues of a corporation, which may be stated in the following form:

The actual value of fixed assets (not merely the book value) should exceed by at least 25 to 50% the bonded obligations outstanding.

The actual value of the fixed assets, plus the value of net current assets (after deduction of current liabilities) should at least equal, and generally considerably exceed, the outstanding preferred shares, income bonds, or other shares bearing contingent charges.

The actual value of tangible assets, plus the actual value of intangible assets, should not exceed the value of the common shares outstanding.

Quite a large number of industrial corporations have followed the principle of issuing bonds and preferred shares up to the net value of their tangible assets, and issuing common shares exactly equal to the value of their intangible assets. Cluett, Peabody and Company, the well-known manufacturers of collars and shirts, carry an account called "Good-will, Patent Rights, Trade-Names, etc," of \$18,000,000, against which the corporation has outstanding \$18,000,000 of common stock. The F. W. Woolworth Company, has good-will \$50,000,000, and common stock \$50,000,000; the Kaufman Department Stores, Inc., of Pittsburg, carries "Good-will, Trade-Marks, Contracts, and Leases" at \$7,500,000, and has outstanding common stock of \$7,500,000. The George A. Fuller Company at its incorporation in 1901 presented a balance sheet showing net quick assets of approximately \$5,000,000 and "Tools, Machinery, and Good-will" of \$10,000,000; \$5,000,000 of preferred and \$10,000,000 of common stock were issued.

In most other cases the correlation between the different forms of securities and the three classes of assets is not so direct and readily visible. But there is, or should be, some measure of relation. We shall find further illustrations both of acceptance and of rejection of this principle as we proceed.

Special Provisions and Forms of Securities

As has been previously stated, there may be any number of forms of security issues. The more important types have been described in previous chapters, but a few examples may be cited here of instances in which it was desirable to make unusual changes in order to adapt the security to peculiarities in the assets or in the market conditions. English practice runs very strongly toward the issuance of perpetual or irredeemable debentures, the idea being that all the debtor cares for is to have his interest paid regularly, thus giving

him a security which is readily marketable. Even the large brewing companies in England, which can hardly be thought to have a business that is beyond all human vicissitudes, have nevertheless issued and sold a large number of these perpetual debentures. In America they are practically unknown and would probably be almost unsalable. In the United States a peculiar security was brought out by a large distilling company some years ago, consisting of a preferred stock issue which was, however, to be redeemed by the corporation and was secured by a first lien on all the whiskey stored in bond. It was further provided that the holder of a share of preferred stock could, if he chose, take a barrel of whiskey in payment of his claim. Even this ingenious arrangement, it is understood, did not bring about the success of the issue.

There has been very little real planning in the financial development of most corporations. The easy and obvious thing to do is to meet each financial difficulty or problem as it comes along, in the hope that there will be no further problems. Frequently the result is to create a maze of conflicting claims, and to impose obligations upon the corporation which seriously interfere with the normal growth of its credit and lead to loss or even to insolvency.

The financial troubles which frequently come to concerns that are fundamentally sound and prosperous are wholly unnecessary. They could be avoided by a moderate amount of foresight and careful planning. A typical instance is that of a knitting mill in an eastern state which is capitalized at \$900,000, \$600,000 common and \$300,000 7% cumulative preferred stock. The quick assets are \$450,000 in excess of its quick liabilities, and the company has a surplus of \$500,000. This corporation, like most all other textile concerns, borrows heavily from the banks. It seldom has loans of less than \$600,000 outstanding, and frequently they rise to \$900,000; the loans are obtained at an average rate of

5½%. The question that has been raised and is now under consideration, is whether it would be desirable to put out an additional \$300,000 of 7% preferred stock at par, thus cutting down the bank borrowing.

To this question there is apparently one sound answer. When bank loans of this concern reach their maximum of \$900,000, these loans are equivalent to the whole capital stock, and the margin of quick assets is too small for safety. A failure to dispose of the products of the mill on the usual terms and at the usual time might suddenly bring on bankruptcy. The case of the National Cordage Company already cited is in point. Because of its extensive and growing business, the corporation is evidently driving toward a possible financial position of serious danger. It is expected that the directors will shortly take action authorizing the sale of preferred stock and reducing the bank indebtedness by a corresponding amount. The result would be to reduce the earnings on the common stock by approximately \$4,500 per year, but this is a small item compared to the gain in safety.

It may be asked why the problem is not solved by placing a mortgage upon the mill and thus borrowing on better terms than through the issue of preferred shares. The answer is that, in the textile industry it is a well-recognized principle that mill property should not be mortgaged. Cotton mills borrow from the banks so heavily that a banker would look with much disfavor on any permanent loan that would outrank his claim.

Incorporating a Partnership

Many puzzling problems arise in connection with the custom which has become common in recent years, of giving up the partnership form in establishing enterprises and substituting the corporate form of organization. During the life of the partnership numerous personal agreements have

probably been entered into which it is difficult either to continue or replace under the corporate form. Moreover, one essential feature of the partnership form is that every partner, irrespective of his financial interest, shall have an equal voice in the management of the enterprise. If there is wide discrepancy between the financial interests of the partners, it is difficult to continue this arrangement under the corporate form. The following is a concrete example which will make clear these difficulties:

Three partners, A, B, and C, conduct a jobbing business established 60 years ago by A's father. A, having inherited his father's estate, is the principal owner and the head of the concern; B, who began 30 years ago as a clerk, is in charge of the production and a large share of the selling; C, who entered as a bookkeeper 20 years ago, is in charge of the financing, office management, and credits. The capital of the firm is \$325,000, of which A owns \$275,000, B \$35,000, and C \$15,000; interest at 6% is paid each partner on the amount of his investment; each partner draws a salary of \$7,200 per annum, and the profits are divided as follows: A 50%; B 40%, and C 10%. The annual sales are about \$750,000, and the net profits \$25,000. An important reason for turning the partnership into a close corporation is in order to allow department heads and some of the salesmen to gain an interest in the business.

It is at once evident, in considering this case, that its difficulty arises out of the fact that profits are divided without any fixed relation either to investment of capital or to the value of services. Six per cent is hardly a sufficient rate of return on the capital employed in a business of this character, so that it is no doubt intended to give some special allowance to A in the division of profits, that will constitute an increased return on his capital. However, this cannot be the controlling interest since B, with a comparatively small investment, re-

ceives 40% of the profits. The problem is to preserve these various rights and claims under the corporate form.

It would be possible to issue 6% bonds of the proposed corporation to A, B, and C to represent their respective investments, but, inasmuch as this is a jobbing business, it would be preferable to issue preferred stock rather than bonds. We will start, then, by providing for the issuance of \$325,000 of 6% cumulative preferred stock; \$275,000 to A, \$35,000 to B, and \$15,000 to C. The best method of determining the total amount of common stock to issue is to capitalize the remaining \$25,000 of profit at some reasonable percentage, say 8%, making the common issue \$312,500. If we assume that the distribution of profits to the three partners is meant to represent their permanent contributions to the upbuilding of the business, this \$312,500 of common stock should be divided among them, 50% to A, 40% to B, and 10% to C. Possibly this division of profits in the partnership is meant rather to represent discrepancies in the abilities of the three men in directing the affairs of the business; if that is the case, these discrepancies should be adjusted by corresponding changes in the salaries of the three men, which in turn would involve a different distribution of the common stock.

Now comes the difficulty of giving each one of the partners an equal voice in the management of the corporation such as he now has in the management of the partnership. The simplest method of accomplishing that result, and generally the most satisfactory, is to create a voting trust, which should not be for more than five years. There would be a possibility, also, of making a part of the common stock non-voting, so as to make certain that each of the partners will be able to elect a member of the board of directors, but this is a somewhat cumbersome device. If it is adopted, it would be well to provide in the by-laws for cumulative voting so as to make impossible a combination of two partners to freeze out the third.

Financial Plan for a Railroad

Another problem, which is of especial interest in illustrating some of the principles discussed, arose in connection with the proposition to finance the construction of a short railroad and the establishment of a steamship service in one of the southern states. The whole project involved an investment, including terminals, of about \$4,183,000. The probable gross earnings after two years from date of opening the road to operation, were calculated at \$2,018,000; operating expenses were estimated at 65%, say \$1,300,000, and taxes and insurance at \$80,000, making the total expense, \$1,380,000, and leaving a net revenue of \$626,125 from which to meet fixed charges and provide a surplus. It is estimated also, that there would be a deficit close to \$100,000 during the first two years of operation. Equipment was expected to cost \$1,650,000. The total capital required was as follows:

Cost of construction	\$4,183,000
Cost of equipment	1,650,000
Loss in first two years of operation	100,000
Working capital	500,000
Total	\$6,433,000

A certain amount of capital required for the earlier stages of construction is necessarily tied up without any income to pay the interest on it, until the road is put in operation. To take care of this expense it would be well to form a construction company to build the road and furnish all other necessary property and cash. The construction company should be prepared to hand over to the railroad company \$600,000, that sum being required to cover the loss of the first two years of operation and to provide working capital. The construction company should also pay interest, taxes, insurance, etc., up to the time the property is handed over to the railroad company. In exchange for the railroad and the cash, the railroad

company would then turn over all its securities to the construction company, which securities the construction company would sell and out of which it would derive its profit. The promoters of the railroad would naturally be the owners of the construction company.

On the basis of normal earnings of \$626,125, the corporation might be capitalized as follows:

	Nominal Value	Cash Receipts to Corporation	Fixed and Contingent Charges
5½% first mortgage bonds on all property, exclusive of equipment, to be disposed of at 90 with a bonus of two shares of common stock to each \$1,000 bond	\$4,000,000	\$3,600,000	\$220,000
6% one to ten-year serial equipment notes	1,500,000	1,500,000	90,000
Annual payment during first ten years of operation to retire above notes			150,000
7% cumulative stock to be disposed of at 90, with a bonus of common to each five shares of preferred	1,500,000	1,350,000	105,000
	<u>\$7,000,000</u>	<u>\$6,450,000</u>	<u>\$565,000</u>

This leaves a balance of \$61,125 a year available for contingencies out of the income of the first ten years.

The common stock required for bonuses to purchasers of the first mortgage bonds and of the preferred stock, is \$1,300,000. The promoters of the enterprise will want some pay for their services, and will probably want to retain control of the company. They should, therefore, issue approximately \$4,000,000 of common stock to the construction company. Under the above estimates \$2,700,000 will be left for themselves.

For the first ten years—unless the earnings should largely

increase—the common stock could not expect to receive any dividends. It will be noticed that \$150,000 worth of serial notes is to be retired each year, and that the interest on that amount each year should be added to the balance available for contingencies. At the end of ten years, not only will there be no interest to pay on the notes but the annual payments on the principal will cease. Thereafter \$301,125 may be disbursed as dividends on the common stock. This means about $7\frac{1}{2}\%$ earnings on the common stock.

It will be noted that in the above arrangement, first mortgage bonds are issued to an amount approximately equal to the actual cost of the property mortgaged. This may seem to be, and is in fact, somewhat reckless financing; yet it must be assumed that the project itself is worth something and that the rails, buildings, and real estate, which are the chief items in cost, are worth more after they are laid down and the railroad is ready for operation, than their actual cost. The preferred stock is more than equivalent to the remaining balance of all the tangible assets and is partly offset by good-will. The proposed common stock issue of \$4,000,000 is offset wholly by good-will. The amount of each class of security that may safely be issued has been determined rather with reference to the earnings than with reference to the assets. It is assumed that there is little likelihood of failure to meet the fixed charges amounting to \$460,000.

Financing an Advertising Agency

At the other end of the scale from a railroad company is an enterprise, such as an advertising agency, which renders a service that is largely of a personal nature analogous to the service rendered by a lawyer, physician, or consulting engineer. It is true, of course, that many of the functions of an advertising agency are of a more or less clerical nature; but the more important functions are advisory and cannot be per-

formed properly except by well-qualified, high-priced men. For this reason the growth of an advertising agency, if it is a healthy, permanent growth, is necessarily a rather slow process. The time and energy of the principals are limited, and, if an attempt is made to spread their efforts over too many undertakings, the result is apt to be unsatisfactory both to their clients and to themselves.

It would seem, therefore, in considering the financial problems of an established agency, that a reasonably rapid growth ought to be financed directly out of the profits of the agency. It is not necessary to maintain a great working capital in proportion to the volume of business handled, for an advertising agency usually pays its bills on the same terms that its own bills to clients are paid by them. For example, if an advertising agency gets a discount of 2% for cash in 10 days, it should give the same discount to its clients and thus secure the cash from them with which to meet the bill.

In one instance, however, an advertising agency was assisting some of its clients to carry on large advertising campaigns by granting them extra time for the payment of their accounts while the advertising agency was paying its own bills on the minute. The result was that it suddenly became necessary to add \$75,000 to \$100,000 to the working capital of the agency. The agency had been in existence for many years, was highly regarded, and was making satisfactory profits, so that its record favored the suggestion that preferred stock be sold to some of the personal friends and acquaintances of the president of the agency. In order to make the stock attractive, however, it was found desirable to give it a participating feature, which would make the possible net earnings run as high as 25%. Under these conditions the stock was sold. It is, however, rather an unusual instance of raising cash by sales of securities, for an enterprise in which personality plays so prominent a part.

Simplicity Desirable

The successful financial plan is not usually one that is highly involved and full of unusual and supposedly ingenious little expedients. It is more likely to be simple and to look beyond the needs of the moment. The chief financial virtue is foresight. Hit-or-miss financing is almost certain to involve either waste or danger.

We will see this exemplified over and over again in discussing the tangled affairs of insolvent corporations which are in process of reorganization. One of the noteworthy advantages of most reorganizations is the greater simplicity which is secured through refunding small and isolated issues into a few large issues with well-defined claims.

It is usually best, also, to work along conventional lines. Originality is only too apt to arouse distrust. There is almost an established routine in organizing public utility corporations, which is about as follows: First mortgage 5% bonds are issued up to 75 to 80% of the cost of construction or, if the company is a consolidation, of the value of the combined fixed assets. These bonds sell to bankers at 95 to 100. 7% preferred shares are then issued for the balance of the tangible assets plus a reasonable amount of good-will. It is expected that the preferred shares will be able to keep up their dividends. They are usually taken by bankers at about 95. Common stock is then issued to such an amount that the remaining earnings, after the period of development is over, will be sufficient to pay at least 4 or 5%. This would be considered a conservative method of capitalization, and in fact it would be difficult to suggest any striking improvement.

CHAPTER X

PROMOTION

Three Steps in Promotion

After a financial plan has been formed and agreed upon by all parties interested, the next step is to put it into operation. If the only persons who are to be identified with the new enterprise are those who have talked it over among themselves and come to a decision as to the plan, there can hardly be said to be a separate process of persuading them to accept the plan and to purchase the securities of the new enterprise. But, when an enterprise is large enough to necessitate the seeking of capital outside the original circle, then there is a distinct stage of shaping the proposition into salable form and of raising the required capital through the sale of securities, which process is known as "promotion."

As to the legitimacy and usefulness of the promotion of sound and beneficial enterprises there can be no real question. The promoter finds an opportunity and turns it into a reality. His work has been in part discredited because the term "promotion" has been misapplied to many swindling efforts to sell worthless stock. In its proper meaning, however, it should be a term of honor. The promoter is the organizer who brings together capital and an enterprise in which capital can be usefully and profitably employed.

If promotion is carried on properly, it is divisible into three distinct stages. First comes the thorough investigation of the new enterprise in all its phases. Sometimes the promoter is so familiar with the enterprise that this stage may be almost overlooked; more frequently, he possesses merely a

general knowledge of similar enterprises, which knowledge enables him readily to grasp the particular enterprise before him. It is dangerous, however, for him to make any assumptions without full and accurate verification. The next step in promotion is the so-called "assembling" of the enterprise, that is to say, forming the financial plan, securing options, chartering the new corporation, and otherwise making the final preparations for selling securities. The third step is the financing of the new enterprise, that is, the actual selling of the securities for sufficient capital to establish the business.

Stages of Investigation

The investigation of a proposed new enterprise may be divided into three stages:

1. A preliminary analysis and review of the field in which many approximate tests of the probable revenue and expenditures may be applied. Sometimes an hour or two of careful figuring and thinking, based upon a general knowledge of the proposition, will determine whether it is worth while to proceed with further study.

2. The next stage is a preliminary study of the important facts, corresponding to the preliminary survey of a new railroad line, which maps out its course but does not attempt to cover all the details. It should be possible at the conclusion of this stage to form a final judgment as to the prospects of the enterprise.

3. Finally there should come a detailed investigation of the location of the enterprise, the sales markets, the personnel or proposed personnel, and of numerous other factors, with a view to making certain that no hidden weakness exists.

This is the process that would be gone through in making a thorough investigation of an entirely new proposition, as for instance, an interurban railway. First, anyone considering the promotion of the railway would get general data as to the

population of the territory, length of the line, expense of buildings, operation, etc., and would determine whether it was desirable to go ahead. Second, he would have a definite survey and study of the traffic possibilities made for him. Third, he would go into detail as to the layout of the line, the cost of right of way, the nature and cost of the franchise, and so on.

Thoroughness in Investigation

Most promoters, however, have to do, not with entirely new enterprises, but with readjustments or combinations of old enterprises; consequently, some of the processes of investigation may be eliminated. The common tendency is to slur over all of it, and the common result is that calculations of prospective earnings, of the amount of capital required and the like, are frequently far removed from the truth. This is just the point at which slipshod methods do most harm.

Frequently the most casual incidents, supplemented perhaps by a little additional thought and some feeble investigation, furnish the sole basis of knowledge for an enormous investment of capital. The formation of the American Malting Company, in 1897, was the outgrowth of an accidental suggestion to one of the large malters "during a conversation held while crossing Boston Common."

At the time of the formation of the United States Shipbuilding Company, in 1902, President LeRoy Dresser, of the Trust Company of the Republic, was, one day, lunching with Lewis Nixon when Charles M. Schwab happened to stop at the table and remarked: "Why don't you buy the Bethlehem plant?" Less than three weeks later Mr. Schwab had agreed to turn over the stock of the Bethlehem plant to the Shipbuilding Company for \$10,000,000 collateral trust bonds, \$10,000,000 preferred and \$10,000,000 common stock.

The formation of the American Bicycle Company in 1898

resulted from a chance remark made by Colonel J. J. McCook, a prominent lawyer, to A. G. Spalding, a manufacturer of bicycles.

"Have you observed the movement toward combinations apparent everywhere?" asked Colonel McCook.

"Yes," replied Mr. Spalding.

"Have you ever thought of the possible application of the combination idea to the bicycle industry?"

"Not seriously."

"I wish you would think it over; it seems to be working in many cases."*

Preliminary Analysis

The preliminary analysis and review of the underlying conditions has been best standardized, perhaps, in public utility fields. A great number of projects of this nature have been presented during the last two decades, and bankers have worked out and come to accept certain well-defined standards. They know, for instance, the approximate amount of gross earnings which can be expected from a given population. Their preliminary estimates of earnings are based upon approximately the following probable yearly receipts, from each person in the territory covered by the public utility:†

Electric light and power companies, ...	\$3.00 to \$6.00 per capita
Gas companies, ...	2.00 " 6.00 " "
Electric street railways in small cities, ...	4.00 " 5.00 " "
Electric street railways in large cities, ...	7.00 " 10.00 " "
Interurban railways, ...	6.00 " 10.00 " "

The New York *Annalist* describes the preliminary survey of electrical railway projects as follows:

*Dewing's "Corporate Promotions and Reorganizations," pp. 251, 272, 484.

†From "Promotion and Organization of Public Service Corporations," by L. R. Nash, of the Stone and Webster Engineering Corporation.

There are 25 or 30 banking houses in New York City that specialize in financing electrical railways. Each of them is supposed to receive 500 to 1,000 proposals for building new lines or purchasing and rehabilitating old lines each year.

In judging these new projects, the bankers take into consideration, first of all, the political attitude of the state or city in regard to public utilities. They have on file tabulated data with regard to the political record and activities of each state. They consider, next, the United States census figures of population and statistics, which indicate the rate of growth of population.

Next, the promoter is asked to pay the expenses and fees of an expert engineer designated by the banking house, who makes a preliminary survey of the proposed line. He tabulates the number of cuts and fills and arrives at an approximate estimate of the cost of construction. He also inquires closely into the cost of rights of way and of terminals. His advance estimates of cost of construction and operation are generally expected to come within 5% of the actual figures.

This preliminary report is then checked against the previous experience of the house. They add to the cost of construction the carrying charges on the investment before it begins to make any return. They may get bids on the construction of power plants. This office analysis and checking is expected to result in very accurate estimates of gross earnings and of outgo.

Some bankers decline to take up any such propositions unless advance estimates show net interest earnings equal to two and one-half times the interest charges on the bonds that will be necessary. Each mile of track should earn a minimum of \$5,000, which is a generally accepted figure for interurban roads.

If the operating cost is 60%, this leaves net earnings of \$2,000. If the construction cost is \$25,000, all provided by bonds at 5%, the interest charges per mile are \$1,250, leaving \$750 per mile to provide for depreciation, unexpected losses, and accidents.

A population per mile in a strip two miles wide on

each side of the road of one thousand is considered a safe minimum. The interurban railroad which exists mostly on paper is not in large favor, as it is believed that most of the choice locations have been occupied.*

Investing Upon an Uncertainty

By way of contrast with the care and the foresight exercised in estimating the possibilities of public utility propositions, as shown in the above quotation, take the experience of the Canadian Sardine Company which some years ago put up a half-million dollar plant at St. John, New Brunswick. The plant was thoroughly modern and efficient and was expected to yield large profits. Unfortunately, there was a period of two or three years after the completion of the plant when the sardines did not run. It was impossible to carry on the business and the company went into bankruptcy. Shortly thereafter, the sardines returned to the Newfoundland fishing banks, but it was then too late. This is a striking, but by no means extreme, instance of establishing a business and investing a large sum of money upon an uncertainty. It is precisely what careful, preliminary investigation will avoid or at least minimize.

Scope of Investigation

We cannot here enter into a discussion of the technical points and subjects which are covered in the investigations of many different projects, for their range is infinite. A well-known engineering firm has had under consideration within the last two years such various projects as: irrigation work in Brazil; a steam railroad in the Philippines; a street railway in South Africa; and hundreds of proposals within the United States. Every one of these proposals that seems worth while is reported upon at great length by a trained engineer and investigator. The stock of information which

*New York *Annalist*, July 20, 1914.

is included in the reports filed with the head office of this firm is enormous. It includes many studies of sociological and political conditions, as well as of more technical considerations of construction and engineering. Each one of the more elaborate reports is well illustrated with photographs pasted into the typewritten pages. Often a report will run from 50,000 to 200,000 words and yet will contain only essential information boiled down to as brief a space as possible.

Some general statements as to questions to be considered in an investigation are included in a paper on "Initial Financing of an Enterprise" by E. K. Chapman, president of the Hudson Trust Company of New York City, which was read at a meeting of the Efficiency Society in March 1914. According to Mr. Chapman, in promoting a corporation which is taking over either tangible property or patent rights, copyrights, good-will, and the like, there are eight points which should receive careful consideration at the outset.

1. The validity of the patents, copyrights, and other titles and rights, or the soundness of the claim of good-will.
2. Strength and dangers of present and potential competition.
3. Likelihood of securing for the new company the proper grade of managerial talent.
4. Sufficiency of capital and dependable resources; this should be enough, not merely to get along if everything goes well, but to include the expenses and losses of the early experimental stage. It is generally not desirable to apply a second time to the people who subscribed the original amount of capital stock.
5. The par value of the capital shares, which should be

low if the appeal is to be made to small investors, and not less than \$100 if the appeal is to be made to large investors.

6. The contract between the corporation and the promoter; the promoter should be reimbursed in cash for his actual cash expenditures, but the compensation for his services should be in the form of shares in the corporation.
7. Necessity of investing a large sum of capital in constructing a plant for manufacturing the proposed product; ordinarily it is less risky to start by having the product manufactured under contract by outsiders or by assembling the parts which have been manufactured under contract.
8. Probability of securing capital from men with experience in similar lines of business or with special information.

It is well for a banker, or investor, or anyone else who has to do with financing new enterprises, to have some such list as Mr. Chapman's before him in order to make sure he is not overlooking any essential point. It may be of some value to comment briefly on a few cases in which the writer was called upon to make a preliminary analysis and to indicate what information ought to be had.

A Simple Example

A proposal which was brought up for criticism some time ago, was to form a new company which should build a modern ice cream plant, with the latest labor-saving devices and the best methods for the manufacture of pure ice cream, with a capacity of 3,000 gallons per day, in the vicinity of an important southern city. Among the more important questions on which exact information should be secured, it was suggested, were the following:

- What is to be the cash investment in real estate? In machinery? In horses, wagons, and other equipment? Will it be necessary to extend credit to any considerable extent to your customers? Is there likely to be any trouble with collections?
- How much do you expect to borrow on mortgage? How much do you expect to borrow from banks? How large will your accounts payable normally be and what will be the average terms of payment?
- What working capital in addition to your permanent investment in buildings and equipment are you providing for?
- What is to be the capitalization of the company? What kinds of stock and notes or bonds are to be issued? Are you sure of getting excellent management?
- Has provision been made for repairs to machinery, fuel, light, office equipment and supplies, drivers and helpers, etc.?
- Will the estimated volume of sales in practice be obtained without prohibitive expense? At what expense?
- What is the earning power of the corporation likely to be after deducting *all* selling and administrative expenses?

A Complex Instance

A proposal of more complexity came from a southern state in which it was planned to build a railroad of less than 30 miles through three prosperous villages and opening up a rich agricultural and lumber country to Port "D" and the sea. Some information was furnished by the intending promoter of this project, but the data as at first submitted was so incomplete that it was necessary to draw up a list of definite questions, which are given below, with a view to securing such

information as would be at once required by a banker or bond dealer if he were to look into the proposition at all.

1. How much traffic is now hauled by existing transportation agencies in this region?
2. How much standing lumber will be made available for shipment by this new road?
3. What are the important markets for this lumber?
4. At what price can it probably be sold in these markets?
5. What, approximately, will be the cost of cutting and of hauling lumber to railroad and loading on cars?
(Answers to the above questions will give a basis for figuring the possible rates on lumber from the point of loading to the markets.)
6. Just how much rail and water traffic through "D" is in sight?
7. What advantages as a port for rail and water traffic will Port "D" have over competing ports?
8. What inducements can be offered which will lead to the diversion of traffic now moving through competing ports to the route through Port "D"?
9. At what rates does traffic now move through competing ports to and from the markets which the promoter hopes to reach by his proposed route?
10. What is the attitude of connecting rail and water lines? Will they be inclined to assist in the development of Port "D" or will they find it to their interest rather to discourage the growth of this port? (This is, perhaps, the most important question of all, for a short railroad, such as the promoter has in view, could scarcely exist, let alone thrive, unless it has the cordial co-operation of connecting lines.)

11. Assuming that connecting lines are friendly, what rate per ton-mile can the proposed railroad probably secure on the through traffic?
12. What will be the exact cost of securing the right of way and constructing the proposed road?
13. What will be the cost of providing docks and other terminal facilities at Port "D"?
14. Do the above estimates contemplate providing a well-built, modern road, or rather a temporary construction which will have to be replaced later?
15. What will be the cost of equipment and of necessary supplies of all kinds?
16. Will it be possible to secure local subsidies or other assistance?
17. Does the promoter have banking connections on which he can rely for assistance in floating the securities of the proposed road?
18. Does the promoter know any capitalists who will probably be willing—provided satisfactory answers to all the above questions are given—to buy the stock issues of the proposed road?
19. Is the promoter able and willing to incur the large expense that will be necessary to secure correct, dependable answers to all the above questions?

The process of securing answers to the questions above listed would in each case probably bring to light many additional questions requiring investigation. Just what these questions may be could not very well be determined in advance, inasmuch as they would result in part from the local conditions under which the project is to be established. By working out a list of questions in their logical sequence and by getting the most complete and trustworthy answers possible, the promoter may be certain that he is leaving nothing of great

importance uncovered. To be sure, there may be unfortunate slips and omissions even in the most thorough investigations, but they will generally be found to be due to peculiarities of the business or of the locality in which it is carried on which escape the eyes of a stranger. For this reason it is always very desirable that the investigator should associate himself as closely as possible with a man who is thoroughly familiar, by long experience, with the peculiarities of the project.

“Assembling” a Proposition

As an illustration of the casual way in which people sometimes take a hand in promoting new enterprises, a case was reported recently of a manufacturer, whom we will designate as A, who was desirous of joining forces with a certain large corporation or of selling out to it. He came into contact with a broker and promoter, B, who was acquainted with a second promoter, C, who had facilities, in B's opinion, for putting through just the deal that A had in mind. B took A over to C's office, introduced him and explained that in view of C's facilities he would step out of the transaction, expecting, however, to be taken care of in case the deal were consummated. Later the transaction was actually effected and the question immediately arose as to what compensation B ought to obtain.

There is no such thing as a standard rate or a standard method of fixing the compensation for financial promoters, and in this case there was no definite bargain in advance. B could certainly have no legal claim, inasmuch as he had performed no service, and it is questionable if he would have any moral claim except for a small honorarium. A mere suggestion or an introduction can hardly be claimed to have a high commercial value. Yet B from his point of view might well reason that, without him, A would probably not have made the deal which was so profitable to him, and that B consequently was fairly entitled to a large proportion of these prof-

its. The question can never be answered one way or the other to the satisfaction of both parties. It is clear that it should never have been allowed to arise. B was careless and unbusinesslike in his dealings. If he thought there was any reasonable chance of putting through the transaction, he should have arranged with C for a definite proportion of his commission. Evidently, under the definition that has previously been given, B did not have in this case a properly "assembled" proposition.

Another case in which, according to the promoter's own story he failed to give himself proper protection, came into the New Jersey courts a few years ago, and was decided by the Court of Errors and Appeals in 1912. It appears that Harry C. Haskins claims to have been the originator of the scheme to unite all the independent lead companies not previously included in the National Lead Company. He went to Thomas F. Ryan, the well-known financier, and enlisted his support. Mr. Haskins charges that after Mr. Ryan and his friends had secured from him all the information they needed, and had made use of his knowledge of the lead business, resulting from years of study, they froze him out of the deal. His claim was that, while Mr. Ryan had made enormous profits as promoter of the consolidation, he himself had received nothing.

Without attempting to express any opinion whatever on the merits of this case, it is plain that in the eyes of the law Mr. Haskins could have little standing. He had no property right in the idea of forming the consolidation; the facts and figures which he submitted to Mr. Ryan were apparently freely given. He may have had a verbal understanding, but, if so, it can best be described as an agreement to make an agreement, fulfilment of which cannot, of course, be compelled in equity proceedings. In other words, the original promoter, Mr. Haskins, according to his own statement, did not contractually protect himself. He went ahead before he had "assembled" his proposition.

Protection of Promoter

Much the same thing has happened over and over again in organizing combinations. A promoter may get the idea of bringing certain companies together and may start talking first with one manufacturer and then with another; in a short time he finds that the idea is being generally discussed and that the manufacturers are talking direct with each other. A little later, if the whole plan looks sound and attractive to them, they are very likely to come together almost of their own accord or through the efforts of some of their lawyers or of some other person besides the original promoter. Unless the promoter is himself a man of such personal acquaintanceship and force that his assistance is a positive and essential factor in forming the combination, it is almost certain that his claims to compensation will get very slight consideration. No one among the manufacturers can undertake to look after the promoter's personal interest; he is supposed to do that for himself. The only method he can successfully follow is to secure contracts or options which will put him in a position of distinct legal advantage. When he has secured these contracts or options, then, and not till then, his proposition is assembled.

Purchase Outright

If the promoters and the financiers working with them are well supplied with cash, their problem may be much simplified. In the promotion of the Mount Vernon-Woodberry Cotton Duck Company in Baltimore, 1899, the promoters acquired fourteen mills by making a separate bargain with each manufacturer and paying to him an agreed price in cash. The price fixed with one manufacturer was not known to the others. In working under this method the promoters were, of course, assuming a large personal risk which it is frequently impossible for the organizer of a large combination to take upon himself.

The next most secure plan is to persuade each concern

that is to be taken into the combination, to grant an option for a limited period at a fixed price. After the promoter has secured enough of these options to assure the realization of the project, he is then in position to form a definite proposition and take it up with bankers for the purpose of securing financial backing. The methods of securing options may differ in each case, and a separate bargain will in each case be driven. When the United States Shipbuilding Company was first promoted, in 1899, Colonel John J. McCook and John W. Young, the promoters, first of all persuaded Lewis Nixon to give an option on his Crescent Ship Yard and adjoining property, with the understanding that Mr. Nixon should consent to act as general manager of the proposed consolidation. In getting together such a proposition as a new street railway, it is often necessary to secure option on rights of way and to obtain franchises from the city and county authorities in order to forestall "hold-ups" at a later period in the development of the proposition. Under such conditions, these options must be obtained very quietly and quickly.

Sometimes the process of "assembling" is completed when the promoter has obtained a control over some one plant or some one portion of the contemplated project which is regarded as essential. This control puts him in a position of strategic advantage. There can be no general rule as to assembling; the most that can be said is that the promoter must put himself and keep himself in a position of mastery over the situation. If he does not do so, he cannot expect, and, as a matter of fact, he has no right to expect, any large compensation for his services. He is playing his game on the implied understanding that in case he obtains a position of advantage he will expect a large return for his services, which must, in fairness, be balanced by the understanding that in case he finds himself at a disadvantage he will get very little return.

The promoter's relation to the people with whom he is

dealing is not that of one banker or business associate to another, but is rather that of buyer and seller of a product which has no fixed value. The promoter is endeavoring to get the highest price obtainable, and the owner of the property or of the cash that goes into the enterprise quite properly wishes to do the best he can for himself.

Preliminary Financing

As soon as the promoter starts to develop a new proposition, he begins to establish—if he has not previously done so—the banking connections that will be of greatest use in connection with the enterprise. These connections should be with banks that are already familiar, through their own experience, either with the line of business or with the field of operations of the business in which the promoter is working. To be specific, if the project is to establish an interurban railroad near Dallas, Texas, the promoter will look for his financial connections either among the New York, Boston, Chicago, and St. Louis banking houses that are accustomed to investigating and floating interurban properties, or among the Dallas bankers who thoroughly know the local situation and can perhaps assist in raising funds from local people. The active co-operation of interested bankers is quite essential to the success of most promotions. The first stage of the financing in which the banker plays his part may be reached when the purchase of options or the outright purchase of property is under consideration. The bankers interested may, at this point, create a syndicate which will advance money to the promoter for the purchase of options on the property, with the agreement that repayment is to be made as soon as the promotion is successfully floated. If the expenditure at this stage is for options only and the promoter's personal means should not allow him to go ahead unassisted, he very likely would attempt to organize a small syndicate among his personal acquaintances who

would be willing to share with him equally the risks and the profits of the promotion. Ordinarily, the bankers would not step in unless outright purchase on a large scale was called for.

The next stage at which bankers' co-operation may be called for is during the period of development, when the promotion involves a great deal of construction; or the period of waiting, when the promotion is a combination that cannot at once be financed by the sale of securities to the public. Let us take an assumed example for the sake of clearness. A new manufacturing company is to put up a plant costing \$1,000,000, and provide machinery and equipment amounting to \$500,000. Let us assume that the product is of such nature that there can be no question as to its marketability. It may sometimes be desirable and possible to raise the full amount of required capital—\$1,500,000 in this case—at the outset and expend it gradually in the construction of the plant, but in other cases this plan will be found impracticable and the question will arise as to how to secure the funds with which to keep construction going while at the same time taking care of the sale of securities.

The customary plan is to place a mortgage on the property acquired or later to be acquired, and to issue bonds up to the extent of the mortgage. These bonds, however, will not be salable until the property has actually been developed. The difficulty may best be met by depositing them with bankers as security for short-term loans and using these loans to provide funds for construction. The banker receives these bonds as collateral, which will eventually be salable and, in case the whole proposition is sound, may consider himself at least fairly well protected. Usually the arrangement is that the bonds shall be delivered as construction goes on, so that the banker may never have on hand a great many bonds representing property that exists as yet only on paper.

The analogous difficulty in case a combination is formed, the securities of which are not at once salable, is met in the same way. The securities are posted as collateral for bank loans and the loans are later paid off as the securities are disposed of.

By means of this preliminary financing, an enterprise can be financed even though the promoter and his immediate friends may have limited funds up to the point when the sale of securities to the public brings in the required amount of capital.

Foresight in Providing Funds

One of the most common errors—and also one of the most dangerous—in organizing a new corporation is to start it off with insufficient capital to carry it through to success. The result is that the new corporation perhaps makes a fine start, gives promise of yielding large profits, and then suddenly threatens to collapse because the supply of cash has been exhausted. Credit is not readily available for most new corporations. The organizers turn hopefully to the natural recourse of selling more stock, and usually find themselves confronted by a blind wall of skepticism. It is a curious fact that an entirely new project, which exists only as an idea and has not yet been troubled by any of the harsh vicissitudes of business existence, appeals strongly to the imagination and is generally able to command capital with comparative ease; whereas exactly the same project six months or a year later, when substantial progress has been made and its profitableness has been in part demonstrated, is no longer appealing and raises new capital with difficulty. The reason is no doubt to be found in the fact that the owner of capital in the second case looks at the project at close range, sees it in its prosaic realization and can hardly conceive it as a great money maker. In the first place his

imagination was left untrammelled. Promoters are insistent, therefore, on one piece of advice in which they all agree: in organizing a new enterprise, raise at the outset all the capital required to bring it to success.

Working Capital Required

One difficulty that often comes up at this point is that of estimating the amount of cash capital required. Among amateur promoters the strong tendency is to underestimate. Even where a new proposition is of quite a definite character—that is to say, where it involves buying a given property or properties at an agreed price, turning out a stable product for an assured market and selling it at a price known in advance—even under such conditions underestimates are frequent. They most commonly arise from two oversights: first, the neglect to provide sufficient working capital, the need for which will be fully discussed later; second, overlooking the incorporation and selling expenses necessarily required to start the corporation and dispose of its capital stock. Selling expense of capital stock may run as high as 25 or 30%, although a much smaller percentage, dwindling to nothing, is more normal.

A typical experience in organizing a small corporation with insufficient financial backing, has recently been related to the author in the following terms:

About two years ago I was induced to purchase stock in the Smith Manufacturing Company,* which owned the patents and intended to manufacture and sell an office equipment device. Only one other person was interested and he took an equal amount of stock and was to be the active man at \$150 per month. It was nearly six months before we were able to get our dies constructed and sufficient stock on hand to go after business, and this work took a lot more money than we anticipated.

*The name is fictitious.

We also had trouble with our finish and replaced a lot of our devices which we had placed in the first few months. Manufacturing difficulties were finally overcome and we have had no other complaints on that score. Our difficulty now is to market the product. Sales for the year have been only about 2,500 units.

Up to this time about \$20,000 has gone into the business and as yet we are hardly making expenses on average monthly sales of \$1,000. It has come to the point now where we must find a more profitable method of merchandising, sell out, or liquidate. We would prefer to sell out, but we have nothing very encouraging to offer a purchaser, so it resolves itself into one of the other two. A first-class merchandising man, in whom both of us feel confidence, could be secured if we were in position to put in another \$10,000 so as to make sure that the business runs for another year. Personally, I am convinced that with the right plan of sale, the whole project would be a tremendous money maker, but we haven't the cash ourselves, don't know where to turn for it, and haven't much of a record to fall back upon.

The stories of loss in handling enterprises that are known to be in themselves sound and profitable, are so numerous, that probably every reader can pick one or more out of his own experience or observation. It will take very little analysis of each one of these cases to demonstrate that the loss has been due to carelessness in one or more of the following features:

1. In not ascertaining all the available facts in advance of making investment.
2. In neglecting to clinch the legal rights of the organizer by means of contracts, options, or the outright purchase of some of the essential property.
3. In failing to establish close relations with financial houses which would be of assistance in carrying the

enterprise through the construction stage and up to the point where securities could be sold as the issues of an established concern.

4. In making insufficient estimates of capital requirements, having in view not only fixed capital, but also working capital and the necessary expenses of selling securities.

All these errors with a little judgment and foresight are easily avoidable.

CHAPTER XI

THE PROMOTER

Professional Promoters

As noted in the preceding chapter, the word "promoter" has come to be associated with Colonel Sellers and J. Rufus Wallingford, and consequently is commonly regarded as a term of reproach rather than of praise. Yet, when it is used in its proper sense, it indicates a man of exceptional energy and foresight who is able to conceive a new enterprise and to set it on its feet. He belongs to the class of men who make for progress.

One unfavorable connotation for the word comes out of the expression, "professional promoter." Each one of the two words in the expression is innocent in itself, but where they are combined they seem to imply an individual who is making his money by his wits at the expense of dupes. There is undoubtedly some truth in this implication, for a certain group of semicriminals who call themselves brokers and promoters make it their business to prey upon struggling enterprises and defraud them while they pretend to assist them.

Yet, there are some men of excellent standing to whom the term "professional promoter," if used in its correct sense, could properly be applied. Dewing mentions, among other men of this type, Charles M. Warner, who took part in promotions so widely separated as the American Malting Company, the Corn Products Refining Company, the Bay State Cotton Corporation, the International Cotton Mills Corporation, and the National Asphalt Company. He mentions, also, Seymour Scott, a small maltster of Lyons, N. Y., whom he describes as "a man of great optimism and emotional enthusiasm who later

promoted another successful combination and still later became interested in the promotion of some beet sugar plants, hypothecated his holdings of American Malting Company stock in order to raise money and lost all of it with the failure of the beet sugar concern.”*

The phrase quoted in the preceding paragraph, “great optimism and emotional enthusiasm,” is a happy characterization of a certain type of professional promoter. He is the type who sees visions and sweeps hard-headed business men into the current of his own enthusiasm. The other type of promoter is the clever schemer—not necessarily dishonest—who pits men and interests against each other, or hitches them into partnerships, relying not so much on the contagion of his own enthusiasm as on his calculations as to the reactions of men on each other.

On the whole, the professional promoter is perhaps less flourishing and a rarer phenomenon than was the case ten to twenty years ago. There have not been so many large promotions or so much call for his services. His place, furthermore, is being taken by the occasional promoters who come from the following classes:

- Local lawyers and bankers
- Engineering firms
- Business executives

There is little to be said, if we are to speak in general terms, of the activities of local lawyers and bankers as promoters. It is enough to call attention to the fact that ordinarily they are natural leaders in organizing new local enterprises. If some western country town is establishing a new creamery or a new cannery; if in some eastern city there is opportunity for a combination of small local manufacturing concerns; if a man of inventive talent gets up a new device and begins to

*Dewing's "Corporate Promotions and Reorganizations," pp. 289, 446.

talk among his friends as to the possibilities of developing it—in any one of these cases the opportunity usually comes straight to the lawyer or banker who is in position to give it some of his time and thought and perhaps to carry it through to success. The number of such cases of local promotions on a small scale is surprising and probably accounts for a considerable proportion of the annual crop of new enterprises.

Engineering Firms as Promoters

It is well known that a few large engineering firms of high standing have organized and financed and now manage thousands of street railway and other public utility corporations, especially in the smaller cities and towns. Among the most important of these firms may be mentioned H. L. Doherty Company, Stone and Webster, J. G. White Company, and H. M. Byllesby and Company. All of these firms, it is stated, have more or less drifted into their present promotion activities. The business of each firm was primarily to carry on professional engineering work. As they grew in size and the expense of maintaining a large staff of high-priced experts became a greater and greater burden, it was found necessary to go beyond merely seeking profitable work for these men and to embark upon the policy of creating work for them. This could be done only by actively organizing and financing new corporations with which the firm then made contracts for engineering service. Promotion at the beginning, then, was a side issue; but it has grown and grown until one, at least, of these firms is regarded as much more distinctly a financial house than an engineering firm.

We might include with this group some of the large manufacturing companies which are actively engaged in financing new enterprises with a view to obtaining their orders for machinery and other equipment. The concern that has followed this policy with the greatest enterprise and success is the

General Electric Company, which through its Electric Bond and Share Company and other subsidiary corporations disposes of the securities of a great number of enterprises which it desires to see developed.

The essential feature of all these arrangements is that the concern which has services or a product to sell does not sit back and wait with folded arms until some one else has succeeded in interesting capital and in building up the enterprises which constitute a market for their services or products. Instead, they look for the opportunities where their services or products can profitably be used, and then proceed to promote the enterprises to handle the opportunities.

All such concerns, after this policy becomes known, are deluged with a constant stream of applications for their assistance in developing new enterprises in which it is thought they might be interested. After receiving these proposals, those which appear to be worth while are investigated along the lines that have been suggested in the preceding chapter. In case the investigation yields a favorable report, they proceed to incorporate and capitalize the new enterprise in accordance with the principles previously discussed. The procedure thereafter differs. Some of the firms work in close connection with banking houses which underwrite the securities of their corporations and proceed to sell them to the general public. Other firms have their own departments or subsidiary corporations for the sale of securities, thus carrying through the whole enterprise from its inception through the investigation, the flotation, the construction of the plant or property, and even beyond this, through the initial stages of its management.

German electrical companies follow much the same policy and in the international markets work in direct competition in this respect with American companies. It is said, however, that engineering firms in other countries have not developed

as financial agencies to anything like the same extent as some of the American firms.

Business Executives as Promoters

In forming combinations among competing manufacturing plants, it is not at all unusual to find the initiative coming from the manufacturers themselves. Sometimes they get together and, through a committee or through informal discussion, agree upon a plan of forming a new corporation which shall take in all the previously competing plants. This was the method of forming the leather, cordage, asphalt, and glucose combinations. In a case of this kind, we hardly speak of a "promoter." There is really not much need for his services, inasmuch as the manufacturers meet of their own accord. Another situation exists in some industries where there is keen competition and possibly some ill-feeling, but where one plant or one individual stands out as a recognized leader, either through size, enterprise, personality, or other cause. If a combination is to be formed in an industry where this situation prevails, it may be easily possible for the leading firm or individual to become the promoter. This was true in the case of the salt, malting, and bicycle combinations. It constitutes a somewhat exceptional case when a business executive or a group of executives in one concern actually promote a combination with their rivals. The case is exceptional for the reason that no man easily submits to taking a position of inferiority to a former competitor or to seeing his competitor, starting from the same level as himself, form a combination and take a large block of promoter's profits. It is far easier for a man to come in from outside in order to carry through such a combination.

The customary case of the business executive as a promoter arises in the formation of entirely new enterprises. The man who takes the lead in such enterprises, is com-

monly the same man who expects to manage them after they are organized. In many respects this is the correct arrangement. It obviates the objection which arises when the promoter forms a combination and then ceases his active connection with it; namely, that the promoter is influenced wholly by his desire to sell stock and float the new enterprise and not at all by consideration of the future requirements of the enterprise. On the other hand, when the future manager of the enterprise himself promotes it, there is the corresponding danger that he will overlook its financial needs while securing his capital—if he is successful in getting it on any terms—by unnecessarily crude and wasteful methods. To be sure, the resulting loss is chiefly in the prospective profits of the promoter himself, so that no one else is likely to object. However, in the interests of men of this type, a few remarks as to points which they should watch in forming their financial plan will not be out of place.

The Promoter's Financial Plan

First of all, it is necessary that sufficient capital should be raised or authorized; yet, on the other hand, it is desirable, if the period of construction and development is to be lengthy, that the sale of securities should be postponed until the corporation is actually on its feet. There may seem to be at first glance no possibility of reconciling these two conflicting requirements. The solution to this problem is to be found in making such connections with banking houses that they will be willing to carry through the preliminary financing and underwrite the sale of the securities of the completed proposition. This is one of the devices universally used in large enterprises, but seldom in small ones. There is no reason, however, why it should not be almost equally well adapted to the small concern which through the local bankers may secure accommodation on the strength of its own securities as

collateral and may later sell those securities and repay the bank loan.

A second point to notice is that the promoter should protect his own interests, for he may be sure that no one else will do this for him. The proper method of taking care of himself is to raise all the capital that is needed, on as good terms as possible, by the sale of bonds, preferred shares, and common shares, retaining for himself the remaining equity in the business. This is the place where many business executives, as promoters, fail to realize the full returns to which they are entitled. They are likely to put in their own money under precisely the same conditions as the money of other people, without reserving for themselves the equitable interest which belongs to the promoter of the enterprise and which any other promoter would easily obtain.

Promoters' Legal Status

Legally the promoter is in a somewhat anomalous situation inasmuch as he is acting as representative of an enterprise which is, perhaps, not yet formed, or which, even if incorporated, is wholly a product of his own. The promoter's actions and promises cannot legally bind the corporation, although the promoter, as an individual, may be called upon to see to it that arrangements concluded on behalf of the corporation are actually carried out. The promoter, furthermore, stands in a limited trust relationship to the corporation and to the holders of securities which he has sold. This trust relationship forbids him from making secret profits at the expense of the corporation. He may make reasonable open profits without objection; as for instance when he buys a given property which is essential to the corporation, at a known price, and transfers it to the corporation at a known higher price. But, in case he should buy this same property and transfer it to the corporation, making a

profit for himself without making known this profit, then he would be guilty of a fraud against the purchasers of the corporation's securities.

Among innumerable cases that might be cited to illustrate this statement, the following description of a Florida land deal has been selected:

In April, 1911, five persons acting jointly as promoters of an enterprise, purchased 23,300 acres of land at \$5.50 an acre—a total consideration of \$128,150. On this contract they paid \$5,000, the remainder to be paid at the rate of \$2,500 per month. They then caused the incorporation of the "Southern Land Company" for \$250,000, and entered into a contract with the new company under which they transferred the acreage above mentioned for \$8 per acre. By further agreement, payments were made by the new corporation direct to the original vendor of the land, so that the five promoters were relieved of all further trouble and responsibility. Their profits were to come in the form of final payments to them after the payments to the original vendor had been completed. Later, legal difficulties between the original vendor and the Southern Land Company arose, which made necessary the giving of notes by the land company and readjustment of their relations. Thereupon the five promoters came forward with a proposition to the land company that they would transfer to the land company their contract to purchase the land at \$5.50 per acre. In consideration for giving up the difference between \$5.50 and \$8 per acre, they would accept \$30,000 full-paid stock in the Southern Land Company. Objection was made to the transaction on the ground that the promoters had no right to any profits whatsoever, inasmuch as they were acting, when they purchased the land, in a trust relationship to the corporation and to the later security holders. The prospectus of the Southern Land Company stated that the land had been purchased at \$8 per acre, but did not state from whom it had been pur-

chased nor what profits had been made on the purchase by the promoters of the corporation.

On the above statement of fact it seems there can be little question but that the promoters gave themselves profits to which they were not entitled. If the corporation had first been formed and an independent board of directors had been elected so that the promoters would then have had to deal with this board, it is probable that no legal question could have been raised as to any profits they might make. But in this instance they were dealing with a corporation which was completely in their own hands, and they appear clearly to have abused this relationship.

Promotion Risks

At the beginning of this chapter the case was mentioned of Seymour Scott who, having carried through two successful promotions, lost everything that he had made on both of them in an unsuccessful beet sugar promotion. Mr. Scott's experience is not abnormal; on the contrary, the probabilities are that loss and failure in promotion is the ultimate result of fully one-half of the serious attempts to start new enterprises.

There are, to be sure, classes of enterprise in which failure has become rare, as for example public utility corporations. The standards for estimating the probable income and expenses of such corporations have become so exact, and the estimating is now so carefully and scientifically done, that there is little reason to fear disaster. The chief risks in these enterprises are, first, the possibility of onerous regulation or partial confiscation of profits by governmental authorities; second, the possibility that the territory which they serve may decline in population and wealth.

Other enterprises, particularly those engaged in manufacturing and trading, are most apt to be shipwrecked through lack of careful calculation, foresight, and provisions for the

future. Yet, in addition to these probable causes of disaster, there are innumerable contingencies which cannot be foreseen. This is true of all business enterprises. In addition to the serious risk that the new enterprise itself may prove to be unsuccessful and all the promoter's profits, represented in common stock, may be wiped out, there is the further risk to the promoter that he may fail to carry through the enterprise and may lose all his own expenditures of money, time, and energy devoted to its promotion. This may easily occur without any fault traceable to the promoter. The writer has in mind one instance in which a year's work, some tens of thousands of dollars of expenses and additional tens of thousands of dollars interested in options were lost to the promoter through the sudden death of one of the principals in a small combination which he was organizing.

Besides the monetary loss, there is constantly a serious risk in promotion, even of the most legitimate kind, of damage to the promoter's business reputation. In order to attract capital he makes many recommendations, which he may believe to be thoroughly justified. If the enterprise is successful, the fortunate purchaser of stock thanks his own excellent business judgment and forgets that he was persuaded to accept the judgment of the promoter; if the enterprise is a failure, these same representations are likely to be used as material for legal and personal attack. After the disastrous failure of the United States Shipbuilding Company, there was a great deal of discussion as to whether the real promoter was Colonel John J. McCook, a New York lawyer, or John W. Young, a New York banker. Colonel McCook was said to have employed auditors who investigated the value and earnings of the plants to be absorbed, and was also said to have introduced two of the principals in the new combination to each other. On the other hand, Mr. Young represented to certain of the vendors that he had employed the auditors; and he was the only person

who apparently possessed their detailed statement. It was claimed further that Mr. Young was the man who actually introduced the two principals just referred to. Dewing expressed the opinion "that Mr. Young was the promoter and that Colonel McCook actively co-operated with him in floating the plan, but could not be considered responsible for certain misrepresentations."*

The instance serves as a clear illustration of the point that an unsuccessful promotion necessarily carries with it some discredit to all who are connected with it, and particularly to the organizers of the enterprise.

Promoters' Profits

Earlier in the chapter some indication has been given of the customary method by which the promoter acquires his profits. The fundamental principle is that he is entitled to whatever remains of the capitalized value of the enterprise after the capital which it requires has been obtained. To make the practice entirely clear, let us take a simple hypothetical case. A promoter determines that a given manufacturing enterprise will ordinarily earn, after it has completed a two-year period of development, in excess of \$100,000 per annum net profits. If he is conservative, he will perhaps figure on creating securities all of which will be salable at par on the following basis:

\$500,000 6% first mortgage bonds	\$30,000
\$250,000 8% preferred stock	20,000
\$500,000 common stock yielding 10%	50,000

Total capitalization \$100,000

We will assume that the corporation actually needs \$1,000,000 cash, and that the expense of investigation, secur-

*Dewing's "Corporate Promotions and Reorganizations," p. 472.

ing options, incorporation, and selling securities amounts in total to \$150,000. Under these conditions, the promoter would probably enter a contract to turn over \$1,000,000 in cash, or possibly property and total assets for which he would actually pay \$1,000,000, in exchange for all the bonds, preferred stock, and common stock of the corporation. He would then be able to sell bonds, preferred stock, and \$250,000 of the common stock, and would retain for himself \$250,000, against which should be offset his expenses of \$150,000. In other words, under all these estimates, his net profits would be \$100,000, which would presumably be realized in common stock.

Naturally the situation is not quite so simple in practice; nevertheless, the same principle can be readily applied of capitalizing prospective income and selling or exchanging all of the securities necessary in order to put the corporation on its feet, the remainder of the securities being left as the profits of promotion. There is, however, another complication to be considered here, namely, the fact that a promoter very seldom works completely alone. It would, in all probability, prove essential for him to secure the co-operation of certain bankers and of men who have some special knowledge or prestige, and he will be compelled to divide his profits with them. Quite frequently the original promoter builds up a more or less formal promoters' syndicate, of which he is manager, and which shares in whatever gain he makes.

The principle that the promoter will accept as his compensation a portion of the final equity in the corporation is well established. Otherwise—in case, for instance, he insists upon receiving bonds or preferred stock—he reveals a lack of faith on his part in the success of the enterprise that would probably be fatal to his whole promotion scheme. This principle is applied in the United States freely, leaving to the promoter a block of the common stock. In Eng-

lish practice another arrangement, which is in some respects preferable, has been common. In addition to bonds, preference shares, and ordinary shares, the organizers of a new corporation frequently cause to be created a final claim on the property, ranking after ordinary or common shares, this final claim being represented by "founders'" shares. The founders' shares ordinarily are entitled to dividends only after certain dividends have been paid on ordinary shares, after which they are entitled to participation in additional dividends. A favorite arrangement is to give the ordinary shares, say, 6% as their preference above founders' shares, and then to divide additional profits equally between ordinary shares and founders' shares. The founders' shares are usually issued to a small nominal amount with a small par value to each share, often only one shilling. In a few instances where the companies have been phenomenally successful, the founders' shares have become extremely valuable, and there are even cases in which separate corporations have been formed in order to hold the total block of founders' shares and to sell interests in this block. The advantage of this English practice is that it defers promoters' profits until after those who have contributed cash have been fully protected.

Illustrative Instances

We may select from Dewing a few instances in corporate practice which will show just how promoters have secured their profits.

In the case of the Mount Vernon-Woodberry Cotton Duck Company, the promoters had remaining in their hands \$6,250,000 in common stock. Figuring its market value at \$25, this amounted to a cash profit of well over \$1,500,000. However, Mr. Parks, the chief promoter, was in no situation to keep all these profits for himself; they were divided to a

great extent among the various mill-owners whose personal co-operation had been necessary.

The United States Realty and Construction Company was incorporated in 1902 with a capitalization of \$30,000,000 preferred and \$36,000,000 common stock. The five promoters, who included some well-known and highly respected citizens of New York, stated publicly that they would receive a profit for organizing the new corporation and for procuring the necessary working capital. The announcement was put in the following form:

It is proper to state that we expect to receive for the responsibility and risks assumed by us in organizing the new corporation, procuring the cash capital, and for the expenses incurred, an individual profit which will or may include the stock of the new corporation remaining in our hands after carrying through the transaction.

The promoters' profits in this case are calculated to have amounted to about \$6,000,000 in common stock, or approximately 10% of the total securities. At the outset the market value was about \$1,800,000, and it had an average value during the first year of \$720,000.

In the promotion of the Glucose Sugar Refining Company, in 1897, a promoting syndicate was formed which received \$100 in preferred stock and \$142.85 in common stock, for every \$100 subscribed in money. In accordance with these terms, the subscribers paid in \$4,500,000 cash, and received \$4,500,000 in preferred and \$6,428,250 of common stock. In addition, the promoters got approximately \$3,000,000 in common stock for special funds, purchase money, bonuses, lawyers' expenses, and the like. The promoter, Joseph B. Greenhut, received direct a fee of \$500,000 in common stock. Using the average quotation immediately after the formation of the combination, and omitting indirect profits, the promoters and

underwriting syndicate appear to have obtained an immediate profit of \$4,500,000.

At the organization of the American Bicycle Company, in 1898, the issues constituted \$9,300,000 preferred, \$17,700,000 common, and \$10,000,000 debenture bonds. For the constituent plants the promoter paid approximately \$6,700,000 in preferred stock, \$11,000,000 in common, and \$7,230,000 in debenture bonds, leaving himself approximately \$2,600,000 in preferred, \$6,700,000 in common, and \$1,800,000 debentures. In spite of these enormous paper profits, Dewing says that after the promoter had paid the charges and commissions of bankers, attorneys, and others, there remained only a small profit for himself.

At the formation of the American Malting Company, in 1897, the amount left over for the promoters after the 22 plants of the company had been purchased, and over \$2,000,000 of cash working capital provided, amounted to \$500,000 of preferred stock and \$7,750,000 common stock. This was out of a total of \$12,500,000 preferred and \$13,750,000 common.

From all of the above instances, it is clear that successful promotion may carry with it very large profits, and yet we must not overlook expenses and risk which seem, on the whole, to make these profits reasonable. After a careful study of various promotions, Dewing comes to the conclusion that "the extravagant feature of a promotion is usually connected with the indirect rather than the direct profit." The promoter, after all, is probably entitled to what he gets.

CHAPTER XII

PROMOTING COMBINATIONS

Development of Industrial Combinations

Among the fields for promotive activities probably the one that has attracted the most public attention is the formation of combinations of previously existing companies. Most concerns are developed at the outset as isolated enterprises. At a later stage, however, nearly every expanding company comes into closer and closer relations with the concerns from which it buys and sells, and may even establish some financial connections with them. It is likely, also, to come into increasingly bitter competition with rival concerns, which competition may either seriously cut its profits or may greatly limit the field of its operations. Thus, there exists an almost universal tendency toward combination along one or both of the following lines:

1. The first type may be called "vertical combination," which means the establishment of joint control over two or more concerns that are buying and selling from each other.
2. The second type may be referred to as "horizontal combination," which means the establishment of joint control over two or more competitive concerns.

Vertical combination is especially common between purchasers of raw materials, which may be wholly or partially monopolized, and the manufacturers of these materials. It is also common, on the other hand, between manufacturers who do not sell direct to the final consumers of their products and

some of the middlemen who intervene. The United States Steel Corporation is a notable example of a complete vertical combination, since it includes great iron-mining companies, ships and railroads for the transfer of ore, blast furnaces, manufactories of finished iron and steel products, and selling agencies, notably the United States Steel Products Company, which handles all the export selling. Here is a complete integrated organization which carries on the whole process of mining, manufacturing, and selling. The United States Steel Corporation in some of its aspects also is a horizontal combination. Examples of combinations between competing concerns are not difficult to find, and will readily occur to every reader.

Naturally, the large combinations, with their hundreds of millions of dollars of capital, have attracted most attention. It is not always realized that the combination movement is going on also among comparatively small concerns, and that the aggregate importance of smaller combinations is probably even greater than the aggregate importance of the huge combinations that have their securities listed on the stock exchanges. The idea of taking over an interest in another concern, or the idea of forming a new corporation which shall hold control of two or more other concerns, is now entirely familiar and is being applied in hundreds of cases. In a great many of the smaller cities, manufacturers who have been operating on a comparatively small scale have in recent years combined their facilities. The remarkable growth of business associations made up of competitive manufacturers or traders has been a factor of importance in facilitating this movement toward small combinations.

If the combination is purely a case of one concern purchasing a controlling interest in one or more other concerns, there is no distinct process of promotion. In cases, however, where a new corporation is formed to take over two or more previ-

ously independent corporations, promotion is an essential feature of the arrangement. Some person, or group of persons, must conceive the combination, must carry on investigations, work out a financial plan, assemble their proposition, see to its preliminary financing, and finally dispose of the securities put out by the new corporation. The process of promoting a combination differs in many particulars from the promotion of a single enterprise, and in view of its importance is worth some separate study.

Fields for Combinations

We have spoken above chiefly of combinations among manufacturing concerns; and this is probably the field in which the tendency has in recent years been strongest. However, it should not be forgotten that there are other fields for combination. Among the trading companies there have been a great many mergers or alliances of department stores and of groups or "chains" of small retail stores. Sometimes these chains of stores have grown up in a very loose association, held together really by the personality of one or two men who are interested in each of the separate stores or plants. This loose association, it may be remarked, is especially common in the trade publication field, where one man will often possess a controlling interest in a number of trade papers, each one of which has its own separate corporation and organization.

An example of a similar arrangement in the retail store field is the so-called Besse System Stores in New England, all of which are directed by L. W. Besse. There is a different partner in each store. The management has already announced that this arrangement is not sufficiently stable and does not admit of scientific methods of administration; and presumably it will be replaced sooner or later by a single corporation which will be a combination of all the Besse

stores. This is the manner in which loose associations of business interests usually develop into formal combinations. Much the same process has been gone through by the F. W. Woolworth Company and the Knox Company, both being owners of systems of chain stores.

The movement toward combination has recently been strong among companies in the moving picture field. In 1913-1914, three film companies, with an aggregate capital of \$1,500,000, were floated by a stock exchange house. At about the same time there was a \$5,000,000 merger of three film-producing companies. In the early part of 1914, a \$25,000,000 amalgamation was being talked of.

Combinations among banks are also not uncommon; the great Continental-Commercial National Bank of Chicago being a noteworthy example. This tendency has been particularly prominent in English finance for the last twenty-five or thirty years. According to Huth Jackson, the number of individual banks in England and Wales declined from 366 in 1887, to 133 in 1913; 209 banks disappearing through purchase or amalgamation. The tendency is successful because it produces stronger banks with a more diversified clientele, which are less likely to be swamped by local disturbances.

Another field in which there has been a great deal of combination is among public utilities—including gas and electric light and power companies, street railways, water works, irrigation works, and the like. Combinations in the public utility field are of a slightly different type from those in the manufacturing field. Usually they include a considerable number of local companies, each one operating in its own community, which communities may be far distant from one another. In fact, it is regarded as a point of strength if the various companies in a public utility combination are not affected by the same geographical or economic conditions, thus minimizing the danger that all of them may be seriously

depressed at the same time. While a combination of this type may be classed as "horizontal," it is evidently made up, not of competing enterprises, but of enterprises which may profitably co-operate in such activities as the purchase of raw materials, securing high-grade engineering talent, comparing experiences, and the like. The great advantage, however, which the public utility combination has to offer is the fact that it can float bond and stock issues on a large scale and give them a national market, whereas the local public utility company experiences difficulty in selling its securities outside its local market. As a result, "about 78.5% of the total gas, electric light, and traction capital of operating public utilities is now owned by holding companies. The average electric light company has about \$342,000 of securities outstanding. The undertaking is too small to finance itself efficiently when it has to increase its capital investment about 20% per annum; that is why the holding company is efficient as a financial medium."*

Difficulties in Forming a Combination

Under the most favorable circumstances, the promoter does not lead an easy life. In investigating whatever proposition he has in mind, he must expend both money and time freely and it is quite likely that his efforts will be fruitless; he must exercise diplomacy and patience in securing his options or otherwise assembling his proposition; he must protect himself with the greatest care and forethought if he is to reap the reward of his efforts; he must approach the owners of capital with a proposition which he believes to be favorable to them, and yet must be prepared for rebuffs and suspicion. These are the customary difficulties in promoting any enterprise.

The above difficulties are doubled or tripled when the

*Article by W. H. Gardiner in *New York Annalist*, June, 1915.

enterprise is a combination of previously independent concerns. And, if the combination includes concerns that have been previously competitive, the promoter is, first of all, confronted with the necessity of conciliating individuals who perhaps for years have been fighting each other with all the weapons at their command. Furthermore, the business interests of each separate concern going into the combination demand that it should make for itself the largest claims that it can reasonably support and should look with much suspicion on the claims that are advanced by the other concerns. Unless the promoter is a man of much force and unusual tact, it is almost inevitable that the negotiations should break off as a result of mutual distrust. This has been the result again and again, even though every person interested may have fully recognized the desirability of the proposed combination for the common good of all.

In addition to the questions and conflicts that arise in determining the financial terms of the combination, the creation of a working organization for the combination is more than likely to break up all negotiations. If the promoter is a true diplomat, he will probably try to postpone consideration of the management's personnel until after previous questions have all been disposed of. Nevertheless, it may, at the last moment wreck the whole project. The promoter must usually make up his mind between one of two courses: either he must bring in an outsider of high standing as the chief officer of the combination and give him discretion to pick the best men he can find, thus creating an efficient working organization, or he must "play politics" and choose the officers from the men whose influence he requires in order to form the combination. If he chooses the first alternative, he must make his appeal most strongly to the men who have capital invested and whose business sense will lead them to respect the necessity and justice of the proposed course of action, even though it may

involve sacrifices on the part of some individuals. If he chooses the second alternative, he must make his appeal primarily to the active officers of the concerns that are to be combined, and must depend upon them to help him in influencing the owners of capital. Unfortunately, this second alternative is too often chosen, and is probably the direct cause of the breakdown of various combinations which should have proved highly successful.

The writer has in mind one combination formed within the last five years, which is still running and on the surface appears to be prosperous. The officers, however, were all chosen because of their influence, not because of their abilities. The president was formerly the head of a small and efficient plant which was much needed in the combination. He is a good manager of a one-man plant, but is wholly without training or ability to control a large organization. The treasurer was the head of one of the larger companies absorbed in the combination; he draws a larger salary than the president, yet has almost no active duties and devotes most of his time to other business enterprises. The vice-president is a relative of one of the bankers who helped to finance the combination. He is supposed to be one of the operating officials, yet he and the president are scarcely on speaking terms with each other. The other officers, including even some of those in subordinate positions, were similarly chosen for political reasons.

It seems scarcely possible that this particular combination should continue to exist much longer. Yet it may happen that an internal reorganization will be effected before it is too late, and thus the combination, which is probably basically sound, will after all, prove to be the success that was anticipated.

The difficulties which have to be overcome in organizing a combination among long-time competitors may be illustrated by recording the facts as to a recent attempt to

organize a combination in the publishing field, as told by one of those interested:

An outside promoter was endeavoring to form the combination, but he was hampered by the fact that he is well known in the publishing field, and had had previous business dealings with the owners of the separate companies. Most, if not all, of the men whom he approached regarded his arguments—whether justly or not is beside the point—with distrust.

One of these men stated, for example, that the promoter was a man of the type who, having himself had several disastrous experiences, had decided that he had become an expert well qualified to tell more successful publishers how to conduct their business.

Inasmuch as the proposed combination looked somewhat attractive to all of the men approached, the promoter was able to arrange for a meeting of these men in his office. At this meeting, which was informal, the promoter presided and undertook to draw out expressions of opinion from each person present. No personal unfriendliness was manifest, and the meeting proceeded harmoniously enough, until the question of the price to be paid for each company taken into the combination was raised. At this point, naturally, it was difficult to reach any agreement, particularly as each one present was more anxious to draw out the others than to present his own ideas.

If the promoter had commanded a great deal of respect, or even if he had been an outsider who was believed to be capable and impartial, he would have been able to put through some definite plan for appraising each of the companies interested. The truth was, however, that he had no more influence than any of the other persons present and his plan for appointing an appraisal committee, with himself as chairman, was coldly received. Inasmuch as no better plan was brought forward, the meeting finally adjourned without definite result and the same group of men were never afterwards brought together.

Preliminary Investigation

Among the questions that should be fully and clearly answered before any combination of going concerns is attempted, are the following:

1. What is the financial history of each concern that is to be considered as a possible member of the combination? How long has it been in existence? Is its organization stable? Are its earnings increasing or decreasing? Are adequate depreciation and other reserves deducted before estimating profits? Is the plant and physical property in good condition?

2. Who are the men engaged in this industry who have shown the most enterprise and good judgment? Will they join in the proposed combination and work together on harmonious terms? Will it be necessary to give positions to incompetents or to make unfair concessions in order to influence men who are essential to the combination?

3. What, if any, advantages as a money maker will the proposed combination have over the separate, independent concerns? Will the combination be in violation of any laws? Will it be necessary to raise prices or otherwise incur any unpopularity in order to secure larger profits? Is it possible to introduce more efficient methods into the management of the various plants without arousing undue hostility at the beginning?

4. Assuming that the combination is agreed to, what should be the financial plan of the proposed combination? Upon what basis can its securities be exchanged for the securities of the independent concerns? On what basis can other securities be underwritten and sold to the public? How much fresh capital will the combination need? Will there remain a block of securities sufficient to compensate all who took part in the promotion, for their respective risks and expenditures?

The questions above suggested are by no means exhaustive,

but merely indicate the lines which the promoter will follow in his own preliminary investigation. If the promoter is himself engaged in the industry in which the combination is to be formed, he will probably be familiar at first hand with the answers to most of the questions listed above. Nevertheless it is unsafe for him to depend altogether on his personal knowledge, which will probably be inexact. The promoter must in any case proceed with much discretion and even with secrecy in gathering the preliminary information that he needs; otherwise, he is likely either to arouse suspicion, which would interfere with his later plans, or to stir up premature discussion and arguments that might lead to personal differences or might even favor the promotion of rival plans.

After the promoter, or his immediate associates if there is a group of promoters, have gathered all the preliminary information available, it will be possible to form a tentative plan indicating about what capitalization the proposed company should possess, and what terms should be offered to all the concerns that are to be included. It is usually safe to assume that this tentative plan will be greatly modified during the progress of negotiations.

The next step, usually, is to meet each of the parties whom he hopes to interest, in a separate, personal conference, go over the whole proposition, and, if possible, bring each concern into line to the extent of expressing interest and willingness to agree to some recent reasonable basis of combination. Usually it would not be considered necessary or desirable to attempt to close definite contracts by this process of holding conferences with the separate interests. The final agreement should result after a general conference where the united views of all the participants in the combination will be expressed.

However, it has already been pointed out that in the case of the Mount Vernon-Woodberry Company the pro-

motors proceeded to purchase outright a considerable number of separate plants, and then went ahead with their financial plans and their sale of securities to the public on their own terms. In other instances, options have been secured or definite contracts have been closed with the large independent stockholders in the constituent companies for the exchange of securities. All these methods of promotion have been utilized at one time or another in order to obtain a complete mastery of the situation, so that no meeting of the various parties interested and no general agreement as to a basis of combination will be called for.

In the usual and typical case, however, the next step after the promoter has assured himself of the favorable reception of the general plan, is to bring together the important representatives of interests that are to be included in the combination, in an endeavor to reach an agreement regarding a basis of combination.

Basis of Combination*

In the promotion of the United States Leather Company, in 1893, the initiative was taken by certain manufacturers who mutually agreed upon the necessity of forming a combination and who carried through the whole project with very little outside advice or assistance, even on the part of bankers. After securing the agreement of the principal concerns in the leather industry to the general principle that a combination was desirable, the leaders of the movement proceeded to appoint committees for the purpose of appraising the physical properties of the independent concerns. It was agreed that the new company should issue \$100 in preferred stock and \$100 in common stock, in return for each \$100 of the appraised value of the physical properties. In this way the

*The statements in this section as to the leather and starch combinations are based upon the exceptionally able and graphic accounts contained in Dewing's "Corporate Promotions and Reorganizations."

new corporation acquired approximately 110 tanneries controlled by 60 different leather houses, about 400,000 acres of bark land, and bark rights on 100,000 acres additional. This was a very simple basis of combination. The plan gave no consideration whatever to good-will, patents, contracts, and other intangible assets—or rather the plan assumed that these intangible assets were uniformly equivalent to the value of the tangible assets. On this basis, the new corporation acquired all the physical properties that it needed.

The next problem was to raise working capital, which was secured through an issue of \$10,000,000 debenture bonds, of which \$6,000,000 were underwritten and issued at par. The underwriting syndicate in this case received \$600,000 par value of common stock as a 10% commission for underwriting. It is, of course, to be borne in mind that the common stock did not have a market value even approaching par, so that the actual underwriting commission was far below 10%.

The later history of the leather combination was unfortunate, but this need not concern us here. The manner in which the combination was carried through and the agreed basis of combination seem, on the whole, to have been fair. The tanners who joined the combination considered the appraisals of their property just; outside tanners, however, criticized the appraisals on which stock was issued as being in all cases considerably inflated.

The first consolidation in the starch industry was the National Starch Manufacturing Company in 1890. In this case the promoter, after making his preliminary investigation and forming his financial plan, secured options on twenty starch manufacturing plants. All the options stipulated that the vendors should receive 25% of the value of their mills in cash; 33 $\frac{3}{4}$ % in bonds; 22 $\frac{1}{2}$ % in first preferred stock; and 18 $\frac{3}{4}$ % in second preferred stock. In addition, each manufacturer was to receive a common stock bonus of 27 $\frac{1}{2}$ %.

The working capital of each independent concern was taken over and paid for in cash.

It was part of this general plan that the promoter himself, through a company of which he was president, should furnish \$1,545,750 cash, for which he received an equal amount in bonds and preferred stock and 100% bonus of common stock. Assuming that the promoter was able to market these securities at the prices prevailing during the first two years following the promotion, his compensation amounted to \$722,677.

It is evident that in this instance, although the promoter was acting on his own responsibility, there was a common basis of valuation and terms of payment for the plants which were turned into the combination. When securities are exchanged it is, in fact, necessary that there should be some such common agreement—or at least an informal understanding—for otherwise there is no method of judging the probable value of the securities received in payment for the plants.

In 1889 another promoter planned to organize a second starch combination, and a meeting was held in the office of Charles R. Flint of New York for the purpose of deciding upon the basis of combination. The minutes of this meeting have been preserved, and are extremely interesting as showing the first stages in the process of organizing a combination.

MEMORANDUM OF MEETING held in the office of Charles R. Flint, June 30, at 10 A.M.

Present: Messrs. Flint, Auerbach, T. P. Kingsford, Higgins, Duryea, Morton, and Allen.

It is agreed to organize the United States Starch Company with a capital of \$2,500,000 preferred 6% cumulative stock and \$3,500,000 common stock. And that the former shall be held in trust by the United States Mortgage and Trust Company, and issued later through bankers to be provided by Mr. Flint. The common stock shall also be held in trust for the owners for such a time as they may elect.

It is agreed and understood that the vendors shall receive \$950,000 in cash, \$1,550,000 preferred stock, and \$3,000,000 in common stock, for their plants and inventories, to be provided for as follows:

First, a loan shall be made by the United States Mortgage and Trust Company for \$950,000 for nine months, same to be paid from the proceeds of the sale of an equal amount of preferred stock to be issued at such time as in the judgment of the Directors may be proper. The proceeds of this loan to be used as follows:

To pay Kingsford	\$400,000
“ “ Morton	175,000
“ “ Graves	350,000
“ “ Duryea	25,000
Total	\$950,000

Second, in addition to the cash paid as above, preferred stock shall be assigned to the vendors as follows:

Kingsford	\$1,100,000 on plant and inventory
Morton	125,000 “ plant
Duryea	100,000 “ inventory
“	75,000 “ plant
Graves	100,000 “ inventory
“	50,000 “ plant
Total	\$1,550,000

which shall be held in trust by the United States Mortgage and Trust Company for account of the owners until the time of issue.

\$3,000,000 of common stock is to be issued to the vendors in part payment of real and personal property turned over to the new company, as follows:

Kingsford	\$2,422,500
Morton	255,000
Duryea	322,500
Total	\$3,000,000

Included in the property turned over by the vendors, it is estimated that there will be about \$750,000 of quick assets, consisting of grain, package materials, and starch, manufactured and in process.

\$500,000 in common stock shall be paid to cover the entire costs of promoting the company, including the charter, the organization, the commission paid in stock for securing the loan, the fee of the bankers who issue the preferred.

Common stock to vendors	\$3,000,000
Common stock to promoters	500,000
Total	\$3,500,000

Typical English Combinations

A noteworthy English combination, effected in 1914, was the acquirement of A. & F. Pears, Limited, manufacturers of Pears Soap, by Lever Brothers, Limited, manufacturers of "Sunlight" and other well-known brands of soap. A. & F. Pears had outstanding £320,000 ordinary shares, on which dividends of 12% had been regularly paid for some years. Under the terms of the combination, these ordinary shares were converted into 12% cumulative preferred ordinary shares of the company of Lever Brothers, Limited, which rank next after its 5% debentures and 6% preference shares. A. & F. Pears, Limited, then increased their capital by issuing 150,000 new ordinary shares, which were purchased by Lever Brothers, Limited, for £150,000. This £150,000 was then invested in Lever Brothers 15% preferred ordinary shares at par; the market value of these shares in normal times being about two and one-half times par.

The purpose of this transfer evidently was two-fold: first, to give Lever Brothers all the voting shares in A. & F. Pears, Limited; second, to provide additional security for the continued payment of the 12% dividends on the new preferred ordinary shares. In addition, A. & F. Pears, Limited, held on

June 30, 1914, investments in outside securities which had cost £220,390, but which showed a depreciation at that time of about £33,000. It was agreed that A. & F. Pears, Limited, should retain £94,843 of these securities which could be held as reserve funds to offset depreciation of the plant and of the leasehold on certain pieces of real estate.

The balance, amounting to £125,547, was taken over by Lever Brothers in payment for which they gave to A. & F. Pears, Limited, Lever Brothers' preferred ordinary shares to the amount of £55,800, worth at the market value of £2 5s. per share, £125,550. The reason for this last transfer was not explained, but it may be presumed to have been intended to simplify the financial relations between the two concerns, and to provide still further security for the continued payment of the 12% dividends on Lever Brothers' preferred ordinary shares.

The principle upon which this combination is based is evidently that of assuring the stockholders of the absorbed company that they are to continue to receive indefinitely the same rate of dividends which they had been receiving in the past. In other words, in exchange for the privilege of controlling A. & F. Pears, Limited, and for the chance of building up still higher profits, Lever Brothers were willing to assume all the risk of the undertaking.

This type of combination is not at all unusual when one or two corporations are to be taken over by a previously existing corporation of high credit standing. It is especially common in the United States in connection with the long-term leases much used by railroad companies. For instance, the New York Central Railroad Company leases the Boston and Albany Railroad Company for a 99-year term, the rental consisting of a guarantee of 8% dividends on Boston and Albany stock, plus the payment by New York Central of all organization expenses, taxes, and other possible deductions from Bos-

ton and Albany income. Similarly, the Western Union Telegraph Company leases the property of a subsidiary company for a 50-year term, the rental consisting of a 5% payment on the stock.

Consolidations

Sometimes two or more formerly independent corporations are not joined under one control by an exchange of securities, but are actually "consolidated" or "merged." The two words just quoted are sometimes used in a popular sense as almost equivalent to "combined," but are here used in their legal sense. A "consolidation" or "merger," technically speaking, consists of the complete union of one corporation with another corporation, so that the charters, corporate powers, and security issues are all combined, making only one corporation in place of the two which previously existed. This is entirely different, it will be seen, from the customary process of keeping alive all the corporations that enter into the combination and simply acquiring voting control over those corporations. A "consolidation" or "merger," in the technical sense, is somewhat unusual; in fact, this form is very seldom used except when a railroad or other company desires to take over in toto one of its subsidiary companies which has previously been the legal owner of a separate piece of property. The largest and most important consolidation that has ever taken place in the United States was that of the New York Central and Lake Shore and Michigan Central Railroad Company in 1914. The prime purpose in this case, it was stated, was to make possible a more extensive mortgage and larger bond issues than could be brought out by either of the corporations separately.

This discussion of forms of combination is perhaps leading us away slightly from the main topic of methods of promoting combinations, for such forms as are treated in these sections are customary only when the corporations concerned

have previously been under common control. The combination in such cases could hardly be regarded as requiring promotion. Nevertheless, a promoter sometimes brings about a combination of a small independent company with a large and powerful company by effecting a lease or a "consolidation" of the two.

Analysis of a Small Combination

In order to illustrate the principles treated in the chapters on promotion in a collected form, and to show how they may be applied in practice, it may be well to review briefly the facts as to a small combination of manufacturing plants located in a western city.

The Western Machinery Company was organized in 1900 for the purpose of manufacturing certain patented specialties. The capital stock was \$150,000, and first mortgage bonds were issued to the extent of \$25,000; \$100,000 of the capital stock was given in payment for patents, and \$50,000 was given to the first promoter for his services in disposing of the bonds at par. The \$25,000 received for the bonds represented the total cash actually invested.

It was quickly found that the business would not prosper with the few specialties that it had been arranged to manufacture, and other specialties intended for the same general market were added. As a result, practically all of the profits which were earned from year to year were spent in securing new patents and in other development. This continued until 1906, in which year a satisfactory profit was made. However, the crisis of 1907 and the depression that followed almost wiped out the business of the company and cut down the profits practically to zero. In the last two years, however, there has been a recovery and net profits are now running at the rate of approximately \$20,000 per annum. The character of the business has changed considerably since its in-

ception, but it may now be regarded as established on a reasonably sound basis. The company, however, is considerably handicapped, its location being unfavorable for the kind of business it is now handling.

A few miles distant from the city in which the Western Machinery Company operates is a related, but not competitive, business, owned outright by a gentleman whom we will call James Smith. He has a small plant worth perhaps \$60,000, and is earning net profits of about \$6,500.

There is also in the immediate neighborhood the plant of a manufacturing company which became bankrupt some years ago. The plant has been closed for over three years. The buildings and other assets, even in their present depreciated condition, are estimated to have a value of well over \$100,000, but could be bought for a much smaller consideration.

The following plan for the combination of the three plants above described was recently under consideration:

It is now proposed to combine these three plants under the name and charter of the first-named company, which is now carrying on an active and successful business. It is believed that the same management which has developed this business in the face of unfavorable conditions can at least go ahead with the successful operation of the plant owned by James Smith and can reorganize and successfully conduct the abandoned business of the company which formerly owned the third plant above named. James Smith is willing to remain with the new organization for a short time and then retire, so there are no personal antipathies or jealousies to be overcome. It is proposed to recapitalize the Western Machinery Company as follows:

	Authorized Issue	Actual Issue
6% First Mortgage Bonds.....	\$500,000	\$150,000
6% Cumulative Preferred Stock...	250,000	180,000
Common Stock.....	250,000	250,000

It is proposed to distribute these securities as follows:

	Bonds	Preferred Stock	Common Stock
Western Machinery Company....	\$30,000	\$100,000	\$250,000
James Smith.....		20,000	
Owners of abandoned plant.....	20,000	40,000	
To be sold to the public.....	100,000	20,000	
Total.....	<u>\$150,000</u>	<u>\$180,000</u>	<u>\$250,000</u>

It is anticipated that the bonds, with a 20% bonus of preferred stock, can be sold to an underwriting syndicate at par. The syndicate will probably be able to dispose of the bonds alone at par, leaving its selling expenses and profits to be covered by the bonus of preferred. Thus the company will realize \$100,000 in cash.

It is further provided in the financial plan that James Smith shall receive in addition to his \$20,000 preferred, \$30,000 in cash, thus leaving \$70,000 for rehabilitation of the abandoned plant and for working capital.

It is further provided that when earnings on the preferred stock amount to as much as 12%, then the 70% of preferred remaining unissued at the time of organization shall be distributed as a bonus in agreed proportion among the owners of the three plants entering into the combination.

It is estimated that the net profits of the combination should average at least \$60,000, or approximately three times the interest and preferred dividend payments, at the outset. The three lines of business, it is stated, fit together splendidly and the combination of the different businesses will provide excellent facilities for manufacturing and shipping which will much improve the efficiency of the two going plants and will make possible the profitable operation of the abandoned plant.

In an independent analysis and criticism of the plan above set forth, it was pointed out that the earnings of the pro-

posed combination appear to be loosely estimated and that a much more thorough investigation of probable markets for the products of the combination, of the selling expenses, and of the actual expenditures required to build up an efficient working organization in the abandoned plant, would be demanded by a conservative investor before putting any of his money into the proposition. Unless it can be demonstrated, not merely as a supposition, but as a reasonable certainty, that the earnings will average \$60,000 or more, there will be no real advantage to the Western Machinery Company in carrying through this combination. After all, the plant which they possess is the only one that is now earning a considerable volume of profits, and this plant will presumably be the chief contributor to the profits of the combination.

It is no doubt true, as stated, that the Western Machinery Company could make use of enlarged facilities advantageously, but the question to consider here is whether a small bond or preferred stock issue, based upon the assets of the company, would not provide facilities for enlarging its operations and earning more profits with less risk than would be the case if they carried through the combination. Under the proposed plan, the Western Machinery Company assumes nearly the whole burden of risk, must contribute its own profits to the payment of interest and dividends, and must rely on its ability to develop new business for the other two plants in order to give a satisfactory return to the present owners of the Western Machinery Company. To state the case in slightly different terms, the most successful of the three companies entering into this plan will be giving up the practical certainty of continued, satisfactory profits, for the uncertainty of developing a new enterprise.

It may be stated in general terms, that the wisdom of combining a going, successful concern with an unsuccessful

concern may almost always be questioned. If the successful concern desires to acquire the assets of the unsuccessful concern, that may best be done by raising cash upon its own credit and purchasing those assets outright. The situation is entirely different from the one which exists when two or more going and successful corporations are combined on the basis of their earning powers.

On the strength of this criticism, it was agreed that the plan was in all probability faulty, and it is understood to have since been abandoned.*

Forming a Combination to Secure Control

It sometimes happens that the promoters of a combination have in mind, not so much the immediate cash profits which they may realize from combining and recapitalizing certain properties, as the ultimate profits which they may realize through obtaining control of the properties. If two or more companies are already capitalized at a high figure, it may be difficult to put through an exchange of securities that will realize much profit; yet the object of securing control with a very small expenditure of cash may be attained.

One of the most remarkable illustrations of this type of combination is the Rock Island Company, which in 1915 went into a receiver's hands. The original company was the Chicago, Rock Island and Pacific Railway Company of Illinois, which up to 1901 had outstanding capital shares amounting to \$50,000,000. In 1901 a controlling interest was acquired through the open market by a group which came to be known as the "Rock Island Crowd" made up of W. H. Moore, Daniel G. Reid, William B. Leeds, James H. Moore, and some minor participants. With the exception of Mr. Leeds, none of these men had had any special experi-

*As the facts cited in this section are not matters of public record, the names and some of the identifying details are altered.

ence or interest in railroad affairs. Their activities in Rock Island were almost wholly in connection with its finances.

In June, 1901, within three months after they had secured control, the capital stock was increased from \$50,000,000 to \$60,000,000, the new shares being sold to the public at par. In 1902 the authorized capital stock was again increased to \$75,000,000 and the new shares sold at par. This \$25,000,000 was used to construct and buy small lines or "feeders" for the railroad.

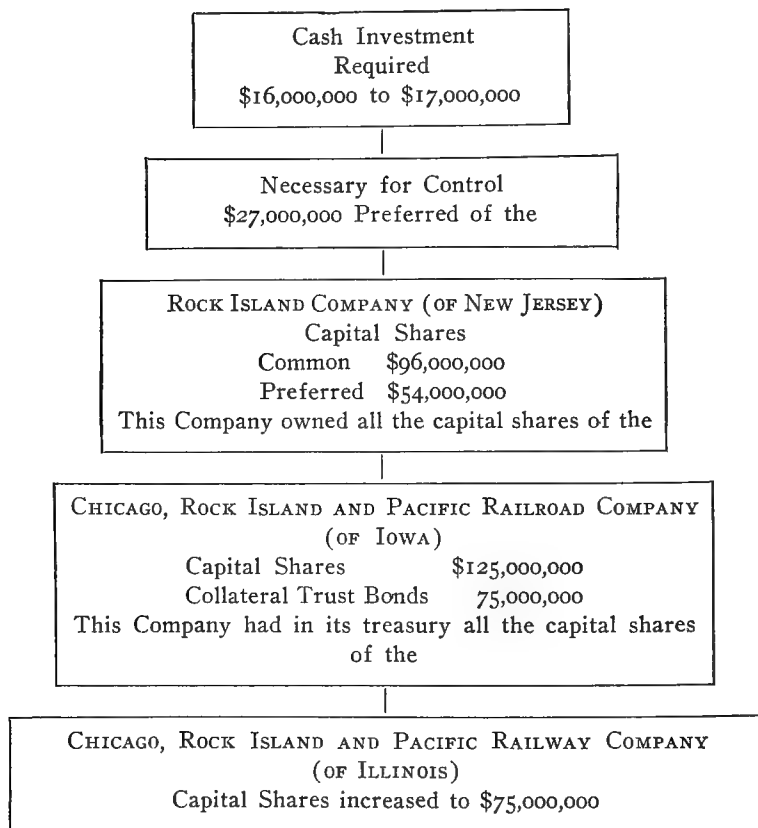
Shortly afterwards a new corporation, the Chicago, Rock Island and Pacific Railroad Company of Iowa, was organized with an authorized capital stock of \$125,000,000, and an authorized issue of collateral trust bonds of \$75,000,000. The collateral trust bonds were exchanged, dollar for dollar, for the outstanding capital shares of the Chicago, Rock Island and Pacific Railway Company.

At about the same time another new corporation, the Rock Island Company of New Jersey, was incorporated and at once issued \$96,000,000 of common and \$54,000,000 of preferred shares. This \$150,000,000 was exchanged for the capital shares of the Chicago, Rock Island and Pacific Railroad Company of Iowa. A peculiarity of the Rock Island Company of New Jersey was the fact that the preferred stock elected a majority of the board of directors. Hence, control of slightly over \$27,000,000 of the \$54,000,000 outstanding preferred stock would give control of the corporation. Inasmuch as the preferred stock sold below par in the open market, the actual cash investment required was \$16,000,000 to \$17,000,000. As the stock was good banking collateral, a large part of this investment could be borrowed.

It is evident that the Rock Island Company controlled the Chicago, Rock Island and Pacific Railroad Company of Iowa, which in turn had control of the Chicago, Rock Island and Pacific Railway Company of Illinois, the operating corpora-

tion. In other words, a relatively slight cash investment would be sufficient to control a corporation having stock outstanding of a book value of over \$75,000,000.

The manner of holding control of the various corporations included in this remarkable scheme, is graphically shown below:



The later history of this combination and its ignominious end are discussed in later chapters.

Making Combinations Successful

It may be remarked, in closing this chapter, that the history of many of the large industrial and of some of the large railroad combinations does not support the notion prevalent some years ago that combinations necessarily achieve economies and improvements in management. On the contrary, the general impression which today prevails among conservative bankers and investors is that most combinations suffer from recklessness and inefficiency of management. It is clear that when the executive organizations of a number of different plants are suddenly disrupted, and a new executive organization takes over at one time the management of all these plants, there are pressing and difficult problems to be solved. The controlling spirits of the new management must be thoroughly trained and resourceful if they are able to retain the good features of the former managements and also add other good features which their larger capital will enable them to command.

Sometimes a combination is formed under auspices so favorable and with so much harmony that a majority of the executive talent engaged in the former independent concerns remains with the combination. If the leader of the combination proves to be a man of unusual breadth and of commanding abilities, he may be able quickly to build up a new organization which will be highly efficient. Ordinarily, however, it happens that the executive officers of the former independent plants, who are, perhaps, not large shareholders in those plants, are not satisfied to accept subordinate positions in the combination. They prefer to go into other lines of business or even to start competing concerns of their own. The malting combination and the various starch combinations are prominent examples. They were formed to limit and forestall competition; their chief result was to increase the amount and intensity of competition.

On the other hand, this difficulty does not necessarily arise when a combination grows gradually by absorbing one or two plants at a time. In that case, the executive organization may also expand accordingly and the concern will be built on a safe basis.

It may further be noted that the possibilities of directing an immense enterprise through the creation of a proper form of organization and other scientific methods of standardizing and testing the various activities, are only in process of development. When the principles of organization are better understood and more commonly applied, the obstacles to the success of combinations will tend to disappear.

CHAPTER XIII

SELLING SECURITIES DIRECT

Four Methods of Selling Securities

When a corporation is organized, and usually from time to time during its life, it is necessary to dispose of some of its securities. The initial capital must, of course, be raised by the sale of securities; subsequent capital may come either by savings out of profits or by fresh sales of securities. We shall take up for review, in the order named, the four methods of sale commonly used:

1. Allotment to insiders or to previous shareholders.
2. Direct sale to the outside public.
3. Sale to banking houses, which in turn dispose of the securities by direct sale to the outside public.
4. Sale to banking houses or brokerage houses, which in turn dispose of the securities through the machinery of stock exchanges.

By the term "insiders," as used above, are meant all those who are themselves familiar at first hand with the affairs of a corporation and are either active in, or closely connected with, the management of the corporation. The term is not used in any derogatory sense, but merely as a convenient designation for those who have intimate relations, so to speak, with the concern. In very small or closely held corporations—assuming that there is good feeling among the various persons interested—it is customary to allot securities as they are issued, to all those actively interested under some kind of mutual agreement. The universal rule of law is that, where new voting shares are issued by an established corporation, every voting shareholder

must have an opportunity to take up a proportion of the new shares equivalent to his proportion of the shares previously outstanding. Unless there is some recent or mutual agreement to the contrary, it is generally found advisable in close corporations to allot new issues of common stock on this basis. Preferred stock or obligations are more likely to be sold to outsiders. There seems to be nothing more that requires explanation in connection with this very common situation.

Establishing Cordial Relations with Shareholders

Corporations already established and going ahead successfully which require fresh capital from time to time for expansion of their activities, find it highly profitable to spend some thought and energy in cultivating the active good-will of their shareholders. This remark applies especially to companies which have a considerable number of shareholders, most of whom are not in close touch with the management of the business. The man who has invested some of his money in the stock of a corporation is likely to feel a certain personal interest in the continued success and growth of the corporation; he usually likes to be considered, not as a complete outsider, but as a person who is entitled to some special information and some privileges. Having once invested in the corporation and having come to follow its fortunes for that reason with more than usual interest, he is peculiarly approachable, if he is kept in an interested frame of mind, when a proposition to make a further investment is brought before him. In the language of salesmanship, two steps—making a favorable approach and arousing interest—have already been taken. The corporation presumably possesses his confidence. The succeeding steps—creating a desire to invest further and securing his decision to do so—should be comparatively easy if he is in a position to make further investments in anything.

The idea of deliberately setting to work to cultivate the

friendship of the body of shareholders not identified with the management, may be regarded as a recent development in business finance. Even yet, there are comparatively few corporations which have grasped and consistently apply the idea. The tendency still persists to regard the average stockholder—usually unknown personally—as merely a name which some clerk enters upon the books. We may go a step farther and say that in many corporate offices he appears to be regarded as an unavoidable nuisance who insists on draining away with his dividend checks—if he is fortunate enough to get them—the earnings which the officers and directors would much prefer to retain for themselves. The truth is that the average stockholder is a human being who likes to be treated as such and who will respond, to a reasonable extent, if the corporation's relations with him are handled with fairness, courtesy, and some degree of cordiality.

When the stockholders of the Northern Pacific Railroad Company received their dividend checks in the early part of 1915 from J. P. Morgan and Company, fiscal agents of the company, they were at least mildly surprised to find enclosed an advertising statement as to a trip to the Yellowstone National Park, which the railway company was promoting, and a return post card on which the stockholder could inquire for details as to the trip.

The National Biscuit Company not long ago sent out to their stockholders a "Pandora Box" which contained samples of many of the company's products. The Loose-Wiles Biscuit Company has followed their example. Swift and Company furnish their stockholders, not merely with a formal annual report, but with a "Year Book" which contains a more intimate review of the internal workings of the company and incidentally recommends that the stockholders purchase some of the company's products. The American Tobacco Company requests stockholders not only to call for the company's brands

of tobacco, but to recommend their use to others. The United States Rubber Company sends to its stockholders a four-page folder urging them to use United States tires on their automobiles.*

A possible motive for the advertising efforts above noted is to increase the sale of the products of these corporations; but it is probable that a more important motive is to cultivate the good-will of the shareholders and increase their friendly interest in the corporation whose shares they hold. Corporations which work along these lines may safely count on finding their shareholders more responsive the next time a new issue of securities is offered to them.

Establishing Cordial Relations with Customers and Employees

In discussing this subject of relations with shareholders, it is convenient—although it might logically come a little later—to treat the subject of relations with employees and with customers. The modern corporation with broad-gauged management is no longer inclined to treat its employees or customers as if they were outsiders entitled to no special consideration. On the contrary, a direct conscious effort is continually being made to bring them into sympathy with the point of view of the management and, whenever possible, to persuade them to participate actively as shareholders in the risks and profits of the business.

Some 25 years ago, when the Emerson Drug Company first put Bromo Seltzer on the market, its distribution was stimulated by giving a share of stock in the company with purchases of a certain quantity of the product . . . and the Bromo Seltzer business was a success as everybody knows who has any contact with the drug trade.†

*The above examples were cited in an editorial in *Printer's Ink*, March 4, 1915.

†From an article in *Printer's Ink* of June, 1915.

Many other companies have since followed this example; but ordinarily they have made the mistake of promising extravagant returns which they were not able to realize and consequently the whole plan has, to some extent, fallen into disrepute. However, the basic idea of tying up the interests of customers in some degree with the sale of the company's products is not unsound.

In a field which is entirely unrelated, we see the same plan adopted by one of the great public utility corporations of the United States—the Pacific Gas and Electric Company. The report of this company for the year ended December 31, 1914, states that a campaign to induce its customers to become further interested in the operation of the company by purchasing first preferred stock had been successful, \$4,000,000 of this stock having been taken up by customers and over \$500,000 additional by employees. In the first six months of 1915, an additional \$1,800,000 of the stock was sold to 1,069 customers. These last figures show that the stock is being widely distributed in small blocks.

It is clear that one result of this policy must be to secure a higher degree of local public interest and to strengthen the bonds which unite the corporation in friendly relations with the communities which it serves.

The same idea is sometimes used by local enterprises. The Twin City Ferry Company of New York recently sent out a circular letter which begins as follows:

This Company has some stock to sell (not much) and realizing the advantage of having our patrons interested in the profits of the business, I am writing some of the people who use the ferry and consequently know its value.

The idea has been used again with success in securing new capital for extending a moving picture theatre. In all proba-

bility the policy of appealing to customers and prospective customers could be applied advantageously in thousands of other enterprises. Many an owner of a small business who chafes helplessly against his "lack of capital" and blames the "trust" for his poor success, could obtain all the capital he needs if he would work out a sound proposition and present it by letter or in person to the people who are already interested as his customers.

The sale of stock of a corporation to its employees is usually regarded as a device for profit-sharing and as fundamentally a method of cultivating the good-will of employees rather than a method of raising capital. This is, in fact, usually the case, and yet we need not overlook entirely the other phase of the transaction. As an example of an excellent presentation of an offer of stock to employees, we cannot do better than quote below from a singularly effective circular sent out in March, 1914, by Charles E. Murnan, Secretary of the United Drug Company. This company is a co-operative corporation, the stock of which is owned by a large number of drug shops throughout the United States. The circular from which the following quotation is extracted was addressed to drug-shop owners who are stockholders in the United Drug Company, with the request that they bring it to the attention of their clerks:

What is here presented is, beyond question, the greatest force for good to your business and ours that has ever been set in motion. It will aid you in keeping good men when you find them because they have an interest to bind them.

Our 7% Preferred Stock has been sold for a long time at \$55 a share, that is, \$110 for two share lots. Its intrinsic value is a great deal more. I have induced our Board of Directors to set aside a block of this stock to be sold to your store managers and clerks at its market price, \$55 a share, and allow them to use the

checks enclosed as part payment, as per terms on back of checks, which will give it to them at par, \$50, and besides they may pay for it by saving a little each week. Each check is good for \$10 credit on each subscription for two shares (\$110). They have ten months in which to pay for it at the rate of \$10 on the tenth of each month. The same terms apply to each two-share lots subscribed for. For instance, if an employee wants six shares (\$330), he would use three \$10 checks for a credit of \$30 on the whole and pay \$30 a month, etc. Subscriptions and credit checks may be sent at once; cash payments begin April 10.

I know what a clerk thinks about, because I have been one. I know what a salary alone means, because I have been in that position. You may have been there also. As long as salary is the only incentive, a clerk will work for little else. You say this is not so in your case, because you have good fellows who are loyal and do the very best they can. No man does the best he can. Each little incentive is additional motive power to his effort and, there being no corners on inspiration, therefore no limit can be reached. You cannot get the best that is in a man unless he looks at life on a bigger scale. Real work and worth are the result of ambition—ambition to do better and be more.

Anybody who saves will give better service and that is what you need in your business. A man's heart is where his interests are. This inducement is given to make your employees take more interest in your business. They will get it only if they agree to save it and add more to it. We want them to have an interest in this great organization just as you have, if only a small one. We are willing to do something for them if they will do more for you and they will do it. Put this proposition up to them and let them decide. They are indebted to you for it because you have made it possible.

You may say to this that \$110 does not amount to anything, that it is not enough to stimulate interest or additional loyalty or anything else. You are absolutely wrong about it. Fortune has never yet been able to

establish a standard. Life is comparative. One hundred and ten dollars to some people is as much as a million to others. I know when I was working in a store, if somebody had given me a chance to get some stock in one of the biggest organizations in the world, I would have been the proudest fellow in my town.

Note the informal tone of Mr. Murnan's circular and the skill with which he appeals to the interests of the proprietors who should be pleased to have their employees invest in the United Drug Company's stock. It is a thoroughly legitimate, effective plan for accomplishing two results: first, disposing of a certain amount of stock at a fair price; second, enlisting the increased interest of a class of men who can do much to increase the sale of the company's products.

While it is true that proper relations with shareholders, customers, and employees should be carefully cultivated in order to be in position to secure their co-operation and to sell them securities from time to time, there is grave danger in a practice which some concerns have been guilty of, viz., that of utilizing their lists of shareholders and customers in an endeavor to sell them the securities of other companies. In 1914-1915 an important correspondence school was subjected to bitter attacks and to serious injury because it was found that its prestige as an educational institution had been used in order to permit its officers to dispose of stocks of various enterprises in which they were personally interested.

Grant of Subscription Privileges or "Rights"

Corporations are not authorized, except under unusual circumstances, to sell shares of stock below par. There is, however, no legal objection—again with minor exceptions—to selling shares which may have a market value higher than par, at par or at any price above par. The law looks only to the formal, theoretical requirement that the nominal value of

a share of stock shall correspond to the amount of cash or property received in payment therefor.

It follows that, whenever the stock of a corporation has a market value well above par, the corporation may issue shares below the market value and give a privilege, which is valuable to their previous shareholders, to purchase the new issues of stock at some arbitrary price well below their market value. The grant of a subscription privilege or "right," as it is customarily called, is one of the highly valued perquisites of stockholders in large and successful enterprises.

There are at least three possible objects that may be in the minds of the directors of a corporation when they decide to grant a subscription privilege to their shareholders:

1. It may be their chief object to raise additional capital by the sale of more stock in the easiest and least expensive way; in which case the subscription privilege will probably name a price not many points below the market price of the stock.
2. The directors may desire to give a special concession in the nature of a dividend to their stockholders at the same time that they raise some additional capital. In this case the subscription price will probably be fixed at a margin of several points below the market price.
3. The directors may wish to increase the outstanding stock of the corporation more rapidly than the earnings are increasing; in other words, they may desire to "water" the capitalization to a moderate extent, and at the same time to raise some additional capital. In this case the subscription price is likely to be far below the normal market price.

Of course, it is common to find these three motives mixed in varying proportions in the directors' minds. It is clear,

however, that in either case one consideration is the belief that fresh capital can be advantageously used in the enterprise. For that reason, we will consider the subscription privilege in this chapter as if it were primarily a means of securing fresh capital. It will be referred to in its other aspects in later chapters.

In the remarks above, it has been assumed that the subscription privilege is given exclusively to common shareholders and applies to additional issues of common shares, which is the ordinary situation. However, it is not at all the necessary situation. Under some exceptional conditions—depending on the terms of their contract with the company—the preferred shareholders may enjoy some subscription privileges. Furthermore, the privilege may be granted not only in connection with the purchase of new common shares, but in connection with the purchase of new preferred or of obligations.

Following is the form in which a “right” was granted some years ago to shareholders in the Union Pacific Railroad Company to subscribe at 90% for 4% convertible gold bonds of the company, the market price of which was somewhat above 90:

WARRANT

\$.....

No.....

FOR SUBSCRIPTION TO
TWENTY-YEAR 4% CONVERTIBLE GOLD BONDS

UNION PACIFIC RAILROAD COMPANY
OFFICE OF THE TREASURER, 120 BROADWAY

New York, N. Y., May 31, 1907.

THIS IS TO CERTIFY that.....
or assigns, is entitled to subscribe at 90% for.....
.....dollars, face value of the TWENTY-
YEAR 4% CONVERTIBLE GOLD BONDS OF UNION PACIFIC
RAILROAD COMPANY, to be issued in accordance with

resolutions of the Board of Directors adopted May 9, 1907, upon surrender hereof, at this office, on or before July 10, 1907, and subject to the adoption of a proposed amendment of the articles of incorporation of the Company at a special meeting of the Stockholders called to convene June 15, 1907.

Payment of such subscription must be made as follows:

	Per \$1,000 bond	Per \$500 bond
At the time of making subscription, on or before July 10, 1907.....	\$200.00	\$100.00
On or before August 9, 1907..	200.00	100.00
On or before September 10, 1907 (which includes adjustment of accrued interest).....	505.42	252.71

Subscriptions may be paid in full at the time of making subscriptions, on or before July 10, 1907, in which case the amount payable will be \$901 per \$1,000 bond, or \$450.50 per \$500 bond, including accrued interest.

This warrant must be returned to this office on or before July 10, 1907, accompanied by the payment of the first instalment; and if not so returned with such payment on or before said date will be void and of no value.

Failure to pay the second or third instalments when and as payable will operate as a forfeiture of all rights in respect of the subscription and the instalments previously paid.

On the back of this warrant are two forms: the first to be signed when subscription is made, and the second, which is an assignment requiring a witness, to be signed if the privilege is disposed of.

.....*Treasurer.*

The reverse side of the preceding form appeared as follows:

SUBSCRIPTION

.....1907.

Treasurer, UNION PACIFIC RAILROAD COMPANY,

The undersigned hereby subscribes for the amount
of bonds covered by this warrant.

(Signature)

(Address)

 ASSIGNMENT

.....1907.

Treasurer, UNION PACIFIC RAILROAD COMPANY,

For value received, the right to make the within sub-
scription is hereby assigned to.....
whose address is.....

.....

(Stockholder)

(Address)

Witness:

(Signature)

(Address)

NOTE: For estates or trust accounts this assignment must
be executed by all the executors, administrators, or
trustees.

These "rights" when given in large corporations, are al-
ways transferable. They are issued as formal documents which
have the general appearance of a stock certificate and are
passed from hand to hand by indorsement in blank on the back,
in the same manner as a stock certificate; consequently, these
"rights" are bought and sold with the same facility as other
kinds of desirable property.

Objections to Subscription Privileges

The basic objection to the granting of subscription privileges is the same objection which applies to all special dividends or bonuses—they inevitably give a speculative character to stock which might otherwise tend to enter the class of investments or semi-investments. A stock receives a dividend, let us say, of 8% per annum, and this dividend has been continued over a series of years and is protected by an ample margin of earnings; naturally the shareholders may look forward with some confidence to the period when the dividends will be increased to a normal level of 10% or 12%, and in view of this expectation the stock will probably sell at a high figure. We will suppose, however, that the directors, in place of building up a surplus and getting ready for regular 10% dividends, decide to grant a special subscription privilege worth \$5 to \$10 per share, in this way increasing the amount of capital stock upon which dividends must be paid and making it impossible to expect more than the indefinite maintenance of 8% dividends. What will be the result? The shareholder, to be sure, will have obtained his subscription privilege, which is desirable, but he will have lost perceptibly in the market value of his holdings and he will have lost the chance of a permanent increase in dividends within the near future.

On the other hand, let us suppose that the directors have raised their new capital by having the preferred stock underwritten at or about its market price. Assuming that this new capital could be used as advantageously as the old capital, they are in position to go ahead a little later with the expected increase in dividends.

From the standpoint of the permanent owner of the corporation's shares, there can probably be little question but that the steady and dependable dividend policy better serves his interests. It is only from the point of view of the speculative purchaser that the granting of special "rights" and

bonuses with the resulting rapid fluctuations in stock market prices is desirable. Sometimes, it may regretfully be admitted, the directors of a corporation find it to their personal advantage to know in advance that the granting of a subscription privilege is anticipated. On the basis of private information, which is not available to all the other stockholders, they may buy or sell with the certainty of making individual profits.

From the standpoint of the community there is considerable sentiment against the granting of subscription privileges on the part of public service companies in so far as they constitute a method of stock-watering. In 1896 the Massachusetts legislature passed an act referring particularly to gas and electric light companies, which includes the following:

In case of an authorized increase of capital stock, the shares shall be offered proportionately to the shareholders at not less than the market value thereof at the time of increase. This value is to be determined by the Board.

In Great Britain electric light and tramway companies may offer new shares to shareholders at par, even though the market value may be much higher. The usual practice, however, is to offer the new shares at only a few points under the market value. But there are still many cases where the shareholders receive substantial bonuses in the shape of "rights."

Figuring the Value of a "Right"

If a corporation has a million dollars par value of stock outstanding, with a market value of, say, \$150 per share, and determines to issue \$500,000 more of the same class of stock, with a subscription privilege to the present shareholders of buying the new stock at \$125; what, under these conditions, is the value of the "right" to purchase one of the new shares?

At first glance it seems obvious that the answer is \$25, but

a little reflection makes it clear that this answer does not take into consideration the effect on the market value of all the shares produced by the new issue. If the corporation were to realize \$150 from the sale of each of the new shares, and if the new capital were to be invested as profitably as the old capital, the market value of the shares would remain unchanged. But the company realizes only \$125, and there must therefore be a general reduction in the market value of shares after the new issue has been brought out. The question, then, as to the value of a "right" requires some mathematical calculations. Perhaps the best method of presenting the solution of our problem, is to quote the following algebraic equations adapted from a statement in the *Wall Street Journal*:

$$\begin{aligned}
 x &= \text{rights} \\
 y &= \text{number of rights needed to get} \\
 &\quad \text{one share} \\
 \text{Selling price} &= \text{value of stock plus rights} \\
 \text{Selling price} - x &= \text{value ex-rights} \\
 yx + 100 &= \text{value of one share to be bought} = \\
 &\quad \text{value ex-rights} \\
 yx + 100 &= \text{market price} - x \\
 yx + x &= \text{market price} - 100 \\
 x(y + 1) &= \text{market price} - 100 \\
 x &= \frac{\text{market price} - 100}{y + 1}
 \end{aligned}$$

By applying this formula to the example just cited, we reach the following conclusion:

$$x = \frac{150 - 100}{2 + 1} = \frac{50}{3} = 16.66$$

The value of this "right" is not therefore \$25, as would have been at first supposed, but \$16.66. The same result may be reached by the arithmetical method as follows:

At the beginning of the operation there is in existence

\$1,000,000 par value of outstanding stock, which at the market value of \$150 = ...	\$1,500,000
The \$500,000 of new stock, being sold at \$125, brings into the treasury of the corporation....	\$625,000

Aggregate value of the \$1,500,000 par value of stock outstanding at the conclusion of the transaction = ...\$2,125,000

Dividing 15,000 (the number of shares with a par value of \$100 each) into \$2,125,000, we have the value of each share as \$141.66. Inasmuch as the "right" entitles the holder to purchase a share for \$125, the value of the "right" is the difference between \$141.66 and \$125, or \$16.66.

It should be explained at this point that the term "right" is used on some stock exchanges to indicate the privilege of subscribing to one share of the new issue. On the New York Stock Exchange, however, the term is used as indicating the privilege that is granted to one share of all the stock then outstanding. In the hypothetical case above stated, the "right" to buy one share of a new issue at the special price would be granted to each two shares of the formerly outstanding stock.

Under the customary practice of the New York and many other stock exchanges, the "right" granted to each of the outstanding shares would be the "right" to subscribe to one-half a share of the new issue at the special price. The result of the above calculations should be divided by two, therefore, in order to give the value of the "right" under the New York definition of the word. The value of the "right" as defined in New York would be, then, \$8.33.

Making Use of a "Right"

A stockholder who receives a valuable subscription privilege may make use of it, according to his own circumstances and judgment, in any one of the following ways:

1. He may actually purchase his share of the new issue at the special price, thus making an especially advantageous investment.
2. In case he does not have capital at hand for this purpose, he may decide to sell his "right" in the open market to some one else who would like to buy the stock or to speculate in the value of these "rights."
3. He may sell "short"—that is, without making delivery—an amount of stock equal to that which he may obtain at the special price under his subscription privilege; in this case he will later take up the stock to which he is entitled and with this stock make his delivery.

The first method is desirable if the stockholder happens to be in a position to buy of this particular stock at the time the privilege takes effect. As most people keep their money invested very closely, it is probable that most stockholders do not make use of their privilege in this manner.

The second method is the simplest, and probably the one that is most used. For this very reason it usually involves more or less sacrifice. Very seldom has it happened that the market quotations for a "right" equal the theoretical value of the "right" as above calculated. There is likely to be a strong pressure to make sales on the part of numerous stockholders, with a limited demand, which naturally makes a price that is favorable to the purchaser rather than to the seller. For this reason many stockholders of considerable means prefer the third method. By selling "short" they take advantage of the optimistic feeling which is likely to maintain the price of the stock nearly up to its former level during the period immediately after the subscription privilege is announced, though the theoretical value of the stock may have considerably decreased. The stockholder who sells "short" under these con-

ditions is taking very little risk inasmuch as he is certain to be able to make delivery when the subscription privilege takes effect and is usually able to sell under the most favorable conditions.

Whether the shareholder exercises his "right," sells it to some one else, or sells "short" and then delivers his new stock, is presumably a matter of indifference to the corporation. In any one of these cases, the stockholder is clearing a profit and the capital which the corporation desires to secure has been obtained.

A question which often arises is whether a corporation needs the support in such a transaction of an underwriting syndicate. This question will be touched upon later (Chapter XV).

Selling at Auction

We may next take up the case of a corporation which desires to raise a considerable amount of new capital either at its organization or at some later stage in its development, and which cannot count on meeting its needs by selling to its own stockholders or to those intimately associated with the business as employees or customers. The corporation, we will assume for the present, either cannot command or does not desire to obtain the services of bankers or stock exchange brokers, but wishes to deal directly with the prospective purchasers of its securities. In other words, the corporation is in the position of wishing to sell its own securities to the public at large without the employment of intermediaries.

The simplest method, and one which is much used among public utilities abroad, although almost unknown in this country, is known as the "auction" or "tender" method. The corporation either disposes of its securities at public auction, or by public advertisement invites tenders and sells to the highest bidders.

This method is required by statute in England of all gas and water companies. It is believed to have originated with the Nottingham Gas Company in 1845, and is now generally agreed to be the most economical method of floating new issues, either of share capital or of loan capital, for companies of this class. The so-called "Model Auction Clause" provides among other things:

1. That due notice of the intended sale be given at least 28 days before the date of the auction.
2. That a reserved price be fixed and sent in a sealed letter to the Board of Trade.
3. That no block of shares offered for sale be of more than £100 nominal value.
4. That the total sum payable by the purchaser be due within the three months from the date of the auction or the acceptance of the tender.
5. That any shares not taken at the reserved price may then be offered to previous shareholders and employees and to consumers.
6. That any shares still remaining unsold shall be again offered for sale and, if unsold after the second attempt, may be disposed of at such price and in such manner as the directors may determine.

The well-known firm of A. & W. Richards of London handles practically all of the auction sales of gas securities, and sales usually take place at the offices of this firm on Tuesday of each week.

The auction or tender method eliminates the immediate cause of speculative fluctuation, inasmuch as it does away with "melon-cutting." There has been little difficulty in obtaining plenty of bona fide bids from permanent investors. Brokers and bankers find that they cannot purchase at a price which will permit them to resell at a profit. There seems to be no

question but that the policy is working well with gas and water companies; yet for some reason it is not applied to other public utility corporations.

In Canada, the Consumers Gas Company of Toronto follows the same practice. During the last several years, it has sold 59,508 shares of a par value of \$50 each at public auction, the prices averaging about \$200 per share. In this country the plan has been adopted only in the city of Boston, where it is provided that the new shares of gas and electric light companies shall be sold at public auction.

In view of the long continued and successful experience of the English gas and water companies in raising capital by this method, it would appear that the advisability of its further application to public utility companies in the United States—and possibly even to other companies' securities which appeal to the investing public—would be well worth careful consideration.*

Finding Prospective Buyers

At the best, however, the auction and tender method above described is not applicable to the great majority of corporations which are not sufficiently well known or well established to secure offers to buy their shares and bonds by the simple process of stating that given securities are for sale. They must go out looking for prospective buyers and must carry on an active campaign for the purpose of disposing of their securities. To determine the amount and nature of the securities to be offered belongs to the field of financing proper; what methods should be adopted in disposing of these securities directly to investors is primarily a selling problem. This problem as applied to the sale of securities can be analyzed as follows:

*See report on "Regulation of Public Service Companies in Great Britain," prepared by Robert H. Whitten, Librarian-Statistician, Public Service Commission, State of New York, First District, Published by the Commission, New York City, 1914.

1. How to obtain the names of prospective buyers.
2. How to approach these prospective buyers in a suitable and attractive manner.
3. How to arouse their interest.
4. How to secure their confidence.
5. How to create a desire on their part to purchase the securities that are being sold.
6. How to secure a favorable decision and consummate the sale.

It is necessary here only to present a few remarks as to the application of the principles of salesmanship to this problem of disposing of securities.

The first method of securing the names of prospective buyers, which occurs to many organizers or managers of small corporations, is advertising or extensive circularizing. This method, however, has proved itself almost worthless for sound, legitimate enterprises, although it is extensively used by unsound enterprises. First of all, the very fact that swindling promoters of alleged oil companies, mining companies, and the like have used this method so largely is almost a decisive argument against it. It has become—perhaps unfortunately—so closely associated with fraud that any offer of stocks or bonds that is made through advertising and circularizing is at once looked upon with suspicion by most conservative men. A more fundamental objection is that the method is bound to be expensive. It is not likely that any securities, unless they should be the securities of companies already widely and favorably known, could be sold by advertising and circularizing at an expense of less than 25 to 40% of their offered price, which is entirely too high for a legitimate enterprise. The selling expense ought not to exceed 5 to 10%.

The plan may be modified to the extent of circularizing only selected lists made up, for example, of the customers or prob-

able customers of the enterprise. If the list is carefully selected, and the circularizing carried on in a dignified and effective manner, this method may sometimes prove inexpensive and successful. The remarks in a preceding section as to the advisability of securing capital from customers and employees support this view. It must be borne in mind, however, that there is grave danger here of arousing the suspicion that the corporation is financially embarrassed or at any rate is not sufficiently well financed to provide funds for proper development.

The third and ordinarily the best method of finding prospective buyers for securities of small corporations is through personal inquiries. It may seem at first glance that this statement is in contradiction to the customary practice in marketing commodities. "Experience has long ago proved," it may be argued, "that making personal inquiries is a slow and highly expensive method of locating prospective buyers for automobiles, for real estate, and for many other high-priced commodities. At any rate it should be supplemented and supported by advertising, circularizing, and other cheaper methods. Why should not the same principle apply to the sale of blocks of securities?"

The answer to this natural inquiry is that the element of confidence in the management of an enterprise is a vastly more important factor in effecting the sale of stocks and bonds than it is in effecting the sale of a tangible commodity. The purchaser of a security does not terminate the transaction when he pays over his money and receives his certificate or his bond. He is just beginning at this point his relations with the corporation and its management. If he is wary, therefore—and the majority of people with capital to invest are wary—he will not part with his capital until he feels well assured of the honesty and competence of the management of the enterprise. When the corporation is well-established and well-known, or

when the offer comes to him through a banking house of high standing, or when he is personally acquainted with the managers, the necessary feeling of confidence is quickly established. If none of these favoring conditions exist, however, the best substitute is to approach the prospective buyer with a personal introduction or recommendation which tends to establish confidence.

Here we have the basic reason for the unquestionable fact that only through the personal influence and activities of the responsible officers or of trusted representatives can the securities of a small corporation be successfully sold to the general public. For this reason the expense of finding prospective purchasers through such impersonal methods as advertising or circularizing is in almost every case prohibitive.

The organizer or manager of a small corporation which needs capital may as well make up his mind at once that he is the man who should find the capital and that he should work through his acquaintances and through the respected business men of his community or of his line of business. He may be greatly surprised, frequently, to find how quickly and easily he can locate capital, the existence of which he had not previously suspected.

The Prospectus

For the same reason that the seller of most commodities needs either a sample or a catalogue, the seller of securities needs a prospectus. Its essential characteristic is that it is a written statement of the record, the present condition, and the prospects of the corporation and of the terms on which its securities are offered for sale. No prospective purchaser of securities, who is not one of the inside managers of the concern, will be likely to buy until after a written statement has been put into his hands and he has had an opportunity to look it over. Even though his analysis of the statement may not be

thorough, still the fact that it is made in writing tends to increase his confidence. Verbal assurances which he discounts acquire greater strength when they are committed to permanent written form. The written statement may take the form of a private letter; it may be a somewhat more formal type-written statement; or, if intended for wider distribution, it may be printed. The form in which the statement is given does not change its essential character: it contains the definite representations on the strength of which the security is being sold, and for this reason is of importance both in effecting the sale and in connection with any legal questions that may later arise.

If the corporation which is selling the securities is well-established and has been running for some years, the most important statements in the prospectus are the records of earnings and the balance sheets. These figures should be scrutinized and analyzed with the greatest care. Attention should be given to omissions as well as to allegations of fact. The record of earnings, for example, should go back, not one or two years, but possibly five or six years. The list of assets in the balance sheet should be checked with a suspicious eye, and it should be noted whether ample reserves for depreciation and loss have been established. Sometimes it is claimed that it would be inadvisable to present records of earnings over a period of years, on the ground that this would be making public information that might be of value to competitors. If the business is of so secret a character that even its records of profits are not to be made known to its stockholders or prospective stockholders, it is certainly not the kind of a business which should offer securities to the public at large.

A common practice in writing prospectuses, which properly arouses suspicion, is the presentation of vague and plausible statements that do not commit the corporation or its promoter to anything definite, and yet are intended to create the im-

pression that remarkable profits are in prospect. In the prospectus of a small copper mining company, for example, it is stated that "copper mining has proved a source of some of the greatest fortunes the world has ever known, and its possibilities are not yet exhausted." This statement is literally true, and in its proper context is certainly not objectionable. But when it appears in a prospectus, with the obvious intention of suggesting that the particular company which is offering its stock is likely to prove a boundless source of wealth, it may well cause suspicion as to the entire sincerity and good faith of the authors of the prospectus. Because of the fact that glowing statements beget suspicion rather than confidence, the writers of prospectuses for high-grade companies frequently go to the other extreme and decline to commit themselves in any way as to the future. They will not even express an opinion. By so doing they may avoid straining anyone's confidence in their statements, but they lose the persuasive power of their own well-founded belief in the future growth of the enterprise. The skilled prospectus writer will steer his way carefully between these extremes.

An important factor in creating confidence, especially in a new corporation, is the list of names of men who are identified with the management or have consented to join the board of directors. Knowing this to be true, many unscrupulous promoters have deliberately set to work to secure "ornamental" directors who, for some consideration or because of personal vanity, are willing to become members of the new board.

Probably this practice has prevailed to a greater extent in the organization of banks than in any other line of business. It is unquestionably a vicious practice and the careful purchaser of securities is likely to be repelled rather than attracted when he sees a number of widely advertised names included in the directorate.

It is always desirable that the prospectus should be dignified

in its form and in its contents. Red ink and buffoonery may conceivably help to sell some commodities, but they will not help to sell thousands of dollars of stock and bonds. A man who is thinking of putting his money into securities, generally looks upon the proposition seriously and does not ask to be either startled or amused.

However, this need not prevent a strong appeal at times to other motives besides money-making. A trust company in a small Texas city, for example, which had been unable to raise additional capital that it badly needed, found that it had no difficulty in getting capital as soon as it put its appeal on the ground of the local pride which should be felt by the leading ranchers and merchants of the community in building up a sound financial institution. The sentimental appeal, if it is used, must of course be sincere and legitimate. Otherwise, it becomes mere bathos and a destroyer of confidence.

It is a well-established legal principle that misrepresentations or fraud in the prospectus may invalidate a subscription to the stock which the prospectus is designed to sell. It is, however, extremely difficult to prove either misrepresentation or fraud. In 99 cases out of 100 they are merely to be suspected. Very seldom does the prospectus writer find it necessary to make statements that are directly false. He insinuates an untruth, but he avoids saying it. Even the most extravagant accounts of the prospectuses of swindling companies rarely contain false statements of fact. Whatever is said as to the future is merely expressed as an opinion.

Limitations of Direct Sale

One advantage of selling securities direct rather than through bankers and brokers is the belief commonly held by the purchasers that in this way they avoid contributing anything to the expense of making the sale. They argue to themselves that, if a brokerage firm were to dispose of a block of securities,

it would require a commission of, say, 5 to 10% or more, whereas when the corporation itself, through its officers or direct representatives, disposes of its securities, no commission need be paid. It is, of course, obvious that there is a fallacy here, inasmuch as the effort and expense on the part of the corporation in conducting the sale is just as truly selling cost as would be a commission paid to bankers or brokers. As a matter of fact, the moment direct selling of its own securities by a corporation gets beyond a certain limited field, it becomes impracticable on account of its high cost. We have already seen that advertising and circularizing will not produce the right kind of inquiries for legitimate propositions except at excessive cost. Personal work on the part of officers or promoters of a corporation, who inquire among their friends and proceed from one man to another until they reach people with money to invest, is also slow and expensive. The idea is not impracticable when the amount of capital to be raised is comparatively small; but as the amount of capital increases, the difficulty and expense of this method become progressively greater.

It is, of course, impossible to say definitely how much capital can properly be raised in this manner. That will depend in part on the personal resources and acquaintanceships of the officers. Some years ago the Continental Rubber Company, which operates in the Congo, was organized as a close corporation by a small group of wealthy New York capitalists. It had a capital stock of \$10,000,000, all of which was readily secured by personal solicitation. On the other hand, an inventor who is not in touch with business men may find it a matter of great difficulty to raise a few hundred dollars. We can perhaps form some approximate standard by considering the fact that banking and brokerage houses rarely care to consider undertaking the sale of securities of corporations which are not capitalized at \$1,000,000 or more; also, they

do not care to sell any block of securities amounting to less than \$200,000 to \$500,000 at the lowest. Blocks of securities of smaller amounts, therefore, cannot be sold ordinarily in any other manner than through the personal efforts of the promoters or managers of the corporation. Blocks of securities of larger amounts can generally, but not always, be sold more cheaply through banking and brokerage houses than through direct personal efforts.

That there are some exceptions to this last statement will at once be granted. For example, a large coal and lumber company has recently undertaken to sell \$15,000,000 6% gold bonds and has sent out a number of high-grade salesmen who are being paid a 10% commission. The success of this attempt is not yet assured. The company has the advantage of having well-known business men at the head and of having large lists of dealers to whom they may go with an especially telling offer.

This general question of the relative expense of various methods of selling securities may be better considered after we have reviewed the methods of selling through dealers and through stock exchanges, as discussed in the following chapter.

CHAPTER XIV

SELLING SECURITIES THROUGH DEALERS

Classes of Security Merchants

The general classes of security dealers correspond to the classes of dealers in merchandise, as follows:

1. Wholesalers
2. General retailers
3. Retail specialists

It will quickly appear that these three classes are not clearly defined; nevertheless it is usually possible to classify a given banking or brokerage house as belonging to one of these groups. The wholesale dealers are interested only in the largest issues and make little effort to sell in small lots direct to individuals. In the United States, J. P. Morgan and Company, Kuhn, Loeb and Company, Speyer and Company, and a number of other firms not quite so well-known constitute this group. When a house of this type undertakes to sell a large issue, it usually proceeds to form an underwriting syndicate composed of firms which belong wholly or partly in the second group and which are equipped to sell the securities direct to the purchasing public.

The second group includes such houses as Spencer Trask and Company; Harris, Forbes and Company; White, Weld and Company, which maintain large organizations of bond and security salesmen and keep comprehensive and valuable lists of people who are known to have money available for investment. Such houses, when they are members of underwriting syndicates, are prepared to assume a large share of the burden

of actually disposing of the securities offered. They may also take up smaller issues of securities wholly on their own account without forming an underwriting syndicate and may dispose of these issues to the public. There is no sharp line between houses in this group and houses in the first group.

The third group, consisting of specialists in the different classes of securities, is more clearly defined. It is distinguished from the second group by the fact that the list of prospective buyers in a specialty house is made up exclusively of people who have shown an interest in the specialty and is not merely a general list of people who have money to invest. The difference is much the same as between a department store and a retail shop which specializes in one line of goods. These specialty houses again differ from the stock exchange brokerage firms which are described a little later in this chapter. It would be impossible to list all of the specialty houses. One deals exclusively in oil stocks; another in the securities of the powder companies; another in equipment bonds and car trusts; another in the first mortgage bonds of public utilities; another in bank, trust company, and insurance company securities.

We may also include in this third group a large number of small banking and brokerage houses scattered over the country which specialize in local securities. Every city of any size has a considerable number of successful corporations the securities of which are from time to time bought and sold. These local firms handle business of this type. Usually they are also the correspondents and representatives of New York houses and are in position to help sell the big security issues in which New York is interested.

Handling an Issue

A brokerage house in good standing which undertakes to sell a bond or a stock issue will first of all wish to inform

itself fully and accurately as to the soundness of the issue. It will carry on a preliminary investigation along the same lines that have been fully described in Chapter X, "Promotion." In case the preliminary investigation is satisfactory and the terms are agreed upon, the house will then, probably through its own engineers and accountants, delve still deeper into the records of the corporation and satisfy itself beyond a doubt of the conservatism of all statements upon which the sale of the security is to be based. Then it will proceed to dispose of the securities. Sometimes an advertisement of the security will be approved, and there may be some circularizing with a dignified prospectus. Generally speaking, the real object of this advertising and circularizing is probably not so much to dispose of the issue immediately in hand, as to build up the firm's list of prospective buyers of securities.

It is this list of prospective buyers which is the firm's chief asset. Having this list, it is not necessary that it should continually incur the great expense above referred to of securing the names of prospective buyers through advertising and circularizing; that is, this expense is spread over the cost of selling many different issues instead of being chargeable wholly to one issue.

It is clear that so far as investigation is concerned the expense is almost as great for a small issue as for a large issue. Furthermore, the large issue can generally be sold in larger blocks than can the small issue. It is likely to be the issue of a better known corporation and is more easily sold. All three of these reasons operate to make the brokerage house anxious to secure the privilege of selling large issues at small commissions, and reluctant to undertake the disposal of small issues even at high commissions.

When the great joint loan of the English and French governments amounting to \$500,000,000 was placed in this

country in the fall of 1915, the bankers accepted for themselves a commission of $1\frac{1}{2}\%$. This is the greatest sale of securities and the smallest commission on record in this country. When the National City Bank of New York in the latter part of 1914 undertook to sell \$15,000,000 of the notes of the Argentine government in this country, the commission was $3\frac{1}{2}\%$. The large bond issues of great railroad corporations are ordinarily sold on a commission of 3 to 5%. The smaller bond issues and the first-class preferred stock issues of industrial concerns are sold at commissions of 5 to 10%. Sometimes commissions go higher, but that is not usual for the reason that the better established houses do not care to identify themselves with any security which requires more than a 10% commission to cover all selling expenses and still leave a satisfactory profit. It is, of course, true that even higher commissions and special bonuses payable in stock of the issuing corporation are not unknown.

When a brokerage house is handling a small issue and finds it difficult to make cash sales, it may frequently resort to "swapping" for other better known securities that are owned by its clients. In this way the brokerage house may obtain bonds or stocks which it can actually sell for cash. The process, however, is more or less risky and expensive and amply justifies a high commission.

Obligation of the Brokerage House

A question that is bound to arise whenever a bond or brokerage house recommends a security which afterward turns out to be a poor purchase, concerns the extent of the obligation which the house should be willing to assume. So far as the legal obligation goes, the house is always careful to protect itself by disclaiming responsibility for the statements of fact which it transmits from the corporation to the purchaser and by clearly setting forth that prophecies as to

the future represent only its opinions and not definite promises. This attitude is in itself entirely correct; yet there remains a certain moral obligation which the better houses are quite willing to recognize. As to how far this obligation extends, there is naturally considerable difference of opinion.

Clearly there is rarely a well-marked opposition of interest in this matter between a well-established banking house of high repute and its customers. The prosperity—the very existence—of the house is dependent upon its ability to retain the unquestioning confidence of a large number of investors. Every time a security which it handles goes wrong, that confidence is perceptibly diminished. The reputable banking house, therefore, takes great pains in the first place to make certain that its statements of fact are fully verified and that its recommendations are justified. As a further protection, it is customary for the banking house to obtain for itself some kind of representation, direct or indirect, on the board of directors of the corporation. It is thus in position to keep itself informed and to exercise some influence on the future policies of the enterprise. If, in spite of these precautions, the corporation's record is unsatisfactory and the market value of its securities decline, the banking house will frequently try to maintain the market price and perhaps will quietly assist its clients in disposing of their holdings. If the market decline seems to be due to extraneous factors rather than to any real falling off in the financial standing or profits of the corporation, the banking house will perhaps be satisfied with doing what it can to maintain the price and with reassuring its own clients. In case the situation becomes worse and the corporation finally goes through insolvency and reorganization, the banking house will in all probability do its best to secure favorable terms for the holders of the securities which it has itself recommended. It

has even sometimes happened that the security merchant will repurchase securities which he has sold and which have afterward declined in value, at their original selling prices; but this is an exceptional case and is not to be expected as a regular policy.

On the whole, as the investing public comes to be better educated in financial affairs, and as the standards of correct practice in these matters become better established, there is evidently a strong tendency toward more complete and unquestioning recognition on the part of the security merchant of his moral obligation. The case is rare where the purchaser from a reputable house has any just cause for vigorous complaint.

Limitation of Sale Through Security Merchants

It was pointed out in the preceding chapter that issues below \$200,000 to \$500,000 are too small to bear the expense of thorough investigation on the part of security dealers and must, therefore, ordinarily be sold direct by the corporation or its promoters. This establishes in a general way a lower limit of the security merchant's activities. On the other hand, very large issues of bonds or shares which soon after their issue will enjoy an active market on an important stock exchange, are frequently best handled with the assistance of stock exchange operations. This does not mean, as will be explained a little further on in this chapter, that the large banking houses do not underwrite and dispose of these securities. It means only that they use a slightly different method. Speaking in general terms, it is usually true that issues of say \$10,000,000 to \$20,000,000 and over, are at once listed on the New York Stock Exchange, and the efforts of the houses which handle the issue are directed toward encouraging purchases through the exchange as well as toward making sales direct to their own customers. This is a method that

differs slightly from the one that has been described. The figures just stated give in a general way the upper limit of security issues that are handled exclusively through the method of direct sale by security dealers to customers.

Besides paying the bankers' commission, the issuing corporation must frequently pay heavy legal expenses as well as fees to accountants, intermediary brokers, and others, which run to a high figure. Inasmuch as arrangements of this kind are of a confidential nature, they are not officially recorded and for this reason it is difficult to give exact figures.

Following is a statement showing the expenses incurred by A. L. Barbour in 1896, in carrying through the sale in London of £400,000 6% debenture bonds of the New Trinidad Lake Asphalt Company:

Underwriting commission, 10%	£40,000
Fee to City of London Contract Corporation, Limited, and to Henry Bell, Esq.	15,000
Expenses of the City of London Contract Cor- poration, Limited	1,022
Fees to Seward, Guthrie and Steele, Attorneys in New York	2,183
Fees to Ashurst, Morris and Crisp, Attorneys in London	1,500
Fees to accountants and brokers and miscel- laneous expense	10,293
	£69,998

This is a selling expense of $17\frac{1}{2}\%$. It is, to be sure, exceptionally high, but it must be admitted that it has often subsequently been equalled.*

A further limitation is to be found in the fact that the decisions of security merchants as to taking on new issues

*Figures taken from Dewing's "Corporate Promotions and Reorganization," p. 419.

are frequently determined as much by their own position as by the intrinsic strength and salability of the propositions. If a banking house has already entered into arrangements to sell certain issues of a given type, it will not be in position to take on new issues of the same type. For its own safety, it would prefer to offer to its customers a diversified list. It has sometimes happened, for this reason, that a really excellent proposition has been refused by all the houses which would otherwise have been glad to take it up.

Requirements of the Security Merchant

As a partial illustration of some of the principles which have been set forth above, it will be of interest to review an actual proposition recently presented to a number of banking and brokerage houses, and to summarize the reasons which influenced all of them to decline to take up the proposition.

Over sixty years ago two brothers established a flour mill in the State of Missouri. The enterprise was successful and the brothers, being men of exceptional ability, took over from time to time other enterprises. In the course of years they became very wealthy. It was agreed between them that after their deaths the properties which they then owned should be vested in a trust and held intact over a period of years for the benefit of their heirs, and this arrangement was carried out. One brother died about twelve years ago and the other about ten years ago. At the time when the proposition was formulated for presentation to banking houses, the period of trusteeship was about to end and, unless some other plan were worked out, the estate was to be appraised and distributed among the heirs.

The property held in trust comprised 3,000 acres of land, a flour mill, an ice plant, an electric light and power plant, and a manufacturing establishment. The power for the industrial enterprises was furnished by the electric light and

power plant, and they were also located so that they could best be operated under a single administrative management.

To break up the estate was certain to involve considerable loss in values. Seeing this situation, a young business man of ability and good standing in the community secured from the heirs an option to purchase the whole estate for \$1,500,000. A record of earnings during the preceding five years showed an average of approximately \$120,000. It was stated, however, that the estate had been loosely managed and that by the use of modern business methods it could be made to yield an annual profit of at least \$300,000. It was estimated that about \$500,000 cash would be needed in order to modernize the plants and to provide ample working capital. The promoter wished, if possible, to bring out a bond issue of \$1,500,000 and was himself prepared to raise the additional \$500,000 required by the sale of common stock.

After presentation of this proposition to a number of bond houses, the following summary of their objections was drawn up:

1. The earnings for the past five years are neither sufficiently large to be attractive to a clientele of small investors, nor to guarantee unbroken interest payments on the bonded indebtedness proposed. In other words, if your outstanding bond issue is guaranteed to yield 6%, on the showing made by the property for the last five years, you have too narrow a margin. The property should be made to yield earnings at least twice the amount of the fixed charges before the proposition would be in shape.

2. The cost to investigate the reliability of the entire property in all its phases would surely be heavy, and might be disproportionate if unexpected obstacles were encountered.

3. The property has for about sixty years been a family affair. You have probably already met with hesitancy on the part of bankers to have any financial rela-

tions with matters involving families. While this attitude is, of course, not always justifiable, it is unquestionably true that the guiding of a proposition through the intricacies of family relations is oftentimes extremely difficult.

4. The fact that it is proposed to put a blanket bond issue on several widely different types of assets adversely affects the proposition. While the bond issue is to cover one property, it is easy to conceive of the trouble which might arise from the administration of several highly different types of organization under one management. Not only might this mean inefficiency in handling these properties, but it would be almost impossible for the bondholders to determine whether each property was yielding a reasonable return or whether it was eating into the profits earned by the other companies.

5. Finally, in the opinion of the bankers, the whole matter is as yet in an embryonic state. It is now a capitalist's, not an underwriter's, opportunity. The proper plan would be to raise at least \$1,000,000 by the sale of stock and to pay the owners of the estate by giving them \$500,000 in cash plus a five-year secured note for \$1,000,000, with the understanding that within the fixed period mortgage bonds would be sold and the note of the estate would be paid off. If this were done, the bonds could now be authorized, but would remain unissued for, say, two or three years or until such a time as the company becomes a smoothly-running, well-oiled mechanism showing a return of 15 or 20% on its valuation. Then, if the bonds were offered, we believe it would be a comparatively easy matter to float the issue.

The plan above outlined did not prove acceptable and the whole project has since been dropped.

Stock Exchange Methods

Earlier in this chapter it was remarked that when security issues of great size are to be floated, it is generally advis-

able to have them at once listed on the stock exchange and to effect at least a portion of the sales through stock exchange transactions. One advantage is that the ready marketability of the security is at once established, thus making it easier to sell it at a high price. Another even more direct advantage is the fact that considerable quantities may be purchased through the exchange by people who are not listed as customers of any of the bond houses which float the issue, or who prefer to buy and sell through the exchange rather than "over the counter."

Inasmuch as a full description of stock exchange methods and of the factors which affect stock exchange quotations would require more space than is here available, it is not feasible to do more than to give a brief review of the main facts.

Fundamentally an exchange is simply a meeting place for people who wish to buy and sell securities. In the eighteenth century the London coffee houses grew to be the natural centers for business dealings, and gradually the custom arose of buying and selling through agents, who made it a point to meet for this purpose. It was a natural step forward to form an organization of these agents or brokers and to establish definite hours and fixed rules to govern the trading, and when that step was taken the stock exchange came into existence. Much the same series of stages has marked the evolution of exchanges in all the other principal commercial cities of the world. There are important exchanges today not only in London, New York, Paris, and Berlin, but in Antwerp, Rotterdam, Vienna, Petrograd, Buenos Aires, Rio de Janeiro, Valparaiso, and numerous other cities. Within the United States the chief exchanges outside of New York, are in Boston, Philadelphia, Baltimore, Cleveland, Cincinnati, Chicago, New Orleans, and San Francisco. This is by no means a complete list. Even some of the smaller cities, such

as Rochester, New York, have stock exchanges of some importance.

All the exchanges are organized on the same general plan. They are non-stock corporations, similar in their essential constitution to clubs. Members are admitted on payment of dues, provided a membership or "seat" has been purchased from some member who wishes to retire. The mere fact that membership has been purchased, however, is not sufficient in itself to guarantee admission. The membership committee may, for any reason that it sees fit, decline to accept the applicant.

Seats on the leading stock exchanges frequently sell at very high figures. Their value is apt to fluctuate a great deal from time to time, depending upon the amount and profitability of the business which is being handled by the exchange. A price of \$70,000 to \$80,000 for a seat on the New York Stock Exchange is not uncommon, though within recent years as little as \$30,000 has been paid.

The brokers who hold membership on an exchange are required to charge standard commissions for buying and selling. On the New York Stock Exchange the brokerage on each transfer of a security is $\frac{1}{8}\%$ of the par value, or \$1.25 per thousand dollars; thus the normal difference between the buying price and the selling price of a stock exchange security is $\frac{1}{4}\%$. On the London Exchange, brokers' commissions are determined by individual firms and have not been so definitely standardized. The buying and selling of securities often reach an enormous volume; for instance, million-share days on the New York Stock Exchange are by no means uncommon. Naturally, much of the buying and selling is at once offset by a corresponding resale or repurchase. A certain portion of the brokers are known as "scalpers" and make it their sole business to take advantage of quick fluctuations in prices. A broker of this type may buy 1,000 shares

with the full intention of reselling within a few minutes or, at any rate, before the close of the day. He is satisfied if he makes a profit of $\frac{1}{8}$ to $\frac{1}{4}$ on the transaction.

Other members of the Stock Exchange seldom or never appear on the floor, but operate entirely through their fellow brokers. The advantage to them of membership lies in the fact that the regular commission on transactions for fellow brokers is reduced to the very low figure of \$2 per hundred shares. By far the great majority of the brokers do little or no buying and selling on their own account, but are satisfied with handling the orders given them by their customers.

On the London Stock Exchange there are two classes of traders, known as "jobbers" and "brokers." The broker deals with outside customers and turns over the actual filling of the order to the jobber. On the New York Stock Exchange the transactions of every day are "cleared" at the end of the day. That is to say, purchases and sales of the same security are checked off against each other so that there need not take place the vast amount of handing certificates from hand to hand which would take place if every sale were to be accompanied by an actual delivery. After purchases and sales have been checked, there remains only a comparatively small residue of actual deliveries required in order to close the day's transactions. On the London Stock Exchange the period of settlement comes only once a fortnight. Three days are allowed for checking up and turning in records of purchases and sales, for giving to brokers the names of the people to whom their certificates are to be transferred, and for making payment and accepting delivery. This complex machinery is required partly because of the English practice of registering the names of all holders of securities. Securities to bearer or securities under the American plan of requiring only indorsements in blank, can be much more easily handled.

Importance of Speculative Dealings

It is doubtless well known to the readers of this volume that the great mass of transactions on most of the exchanges have a speculative character. A great many securities, to be sure, are actually taken out of safe deposit boxes and brought into the market to be sold outright, and a great many securities are every day purchased to be held as permanent investments; yet the speculative buying and selling overshadows investment buying and selling.

The activities of the "floor traders" or "scalpers" who buy and sell for a profit of $\frac{1}{8}$ to $\frac{1}{4}\%$ have been mentioned. Many of these traders, though not all, make it a point to match all their purchases and sales before the end of every business day, thus reducing their risk of heavy loss to a minimum. These men proceed almost as much by intuition as by reasoning. If they see in the manner of bidding of other brokers, or "feel it in the air," that a given security is tending upward, they will help along the movement by making a purchase with the expectation of reselling a little later at a slight profit. One result of their activities is to concentrate attention and the volume of transactions on a few active securities. Their business thrives on rapidity of fluctuation in prices. However, their operations tend to restrict the range of fluctuation for they are ready to buy on a momentary drop in price or to sell on a momentary rise, and to resell or rebuy as soon as the normal level is again reached.

A second group of speculators consists of brokers and of others who are in close relation with the Wall Street market and who carry on buying and selling campaigns with the expectation of "cashing in" within a few weeks or months. Sometimes a group of these operators will form a syndicate for the purpose of "bulling" or "bearing" the price of a security. Through "matched" orders for buying and selling they create an artificial activity, and bring about great changes

in quotations. Their calculation is that sooner or later outsiders will be attracted by the movement and will endeavor to go along with it. By gradually feeding out or repurchasing the security in which they are interested, they may be able to clear a large profit for themselves.

A third group of speculators consists of men who possess a real or fancied knowledge of the intrinsic value of a security, and who buy or sell when the market price is a considerable distance away from what they believe to be the normal price, in the expectation that at some later date the normal price will be reached and they may realize a profit. Included in this group are officers and directors of corporations the securities of which are listed on the exchange, who should be in position to know more about the real standing and probable future showing of their corporation than anyone else. Unfortunately for these men, it frequently happens that they do not give proper weight to general market influences which affect the whole general level of security prices. It is not at all an uncommon case for a man who is thoroughly well acquainted with a given corporation to form an entirely mistaken idea as to the market value of its securities.

A fourth group of speculators consists of the "lambs" who are not equipped with the experience and insight of the "floor traders," do not possess the knowledge of market conditions and financial resources of the larger operators, and are not acquainted with given securities as corporation officials are. For the most part they simply gamble on the strength of "tips" or of hazy impressions; and it can never be more than a temporary accident if they happen to make profits. The number of these people and the volume of their transactions is often exaggerated, but their losings nevertheless provide a steady source of revenue for the better informed and more skilful speculators.

Making a Market

In disposing of securities through stock exchange operations, it is essential, first of all, that public interest should be aroused and that the volume of transactions should be of sufficient size to attract attention; otherwise the speculative buying, which constitutes the great bulk and which must be relied upon to take the new securities off the hands of the syndicate managing the flotation, will be lacking.

"Making a market" is accomplished chiefly through two lines of effort; first, through providing for a sufficient volume of transactions to arouse the interest of brokers and professional stock market operators who in such a case will buy and sell in the hope of making substantial profits out of the fluctuations. When the market for a given issue is successfully manipulated, the volume of transactions will become so large that the syndicate carrying through the flotation—which probably will be engaged simultaneously in buying and selling so as to gain a control over the price—should find it possible to sell every day during the movement, a little more than it buys. Thus it will gradually get rid of its own holdings without causing a fall in the price. At the same time, through direct sales outside the exchange, which will be facilitated by the excellent quotations on the exchange, it will probably dispose of the rest of its holdings.

The second essential factor in making a market is favorable publicity. When a new security is to be brought out and listed on the stock exchange, it is generally the case that for some weeks or possibly for some months in advance, the financial press and the financial pages of the daily newspapers are liberally supplied with press notices intended to arouse glowing visions of the prosperity of the corporation. Let us take a concrete example. Beginning early in the summer of 1914, news items began to appear relating to the intended formation of the Sterling Gum Company, which was to put

on the market some new brands of chewing gum. The names of some business men of good standing were mentioned as being the organizers and prospective directors of the new company. Throughout the summer and fall, such items as the following frequently appeared:

An official of the Sterling Gum Company says: "Our selling campaign is now well under way. The reception accorded our brands, both new and old, here and in Canada, has exceeded our greatest expectations. Repeat orders within a few days after first allotment have been the rule rather than the exception."

The Metropolitan Tobacco Company, the largest tobacco jobber in the United States, is handling Sterling brands in the New York district, and its report to the Sterling Gum officials has been of unusually big sales in and about New York City.

Sterling Gum Company has one brand which it is selling exclusively in Canada. This brand is manufactured in Toronto. Its selling agent there reports its initial sale the largest of any newly introduced gum in the history of the Dominion. Those who are directing the affairs of the Sterling Gum Company state that the "inserts" similar to those being used by many of the large tobacco companies, are proving as efficient a means of pushing new gum brands as they proved in the selling campaign of brands of tobacco goods.

The new plant of the Sterling Gum Company in Long Island City will be a five-story factory building on the south side of Harris Avenue between Ely Avenue and William Street. It will be a modern fireproof steel structure to cost in the neighborhood of a quarter of a million dollars. The Sterling Gum Company has taken a long term lease at an aggregate rental in the neighborhood of \$300,000. The plant will be ready for occupancy about April 1, 1915. It will be opened with a force of over 1,000 employees.

The common stock of this company was finally brought out, and perhaps under ordinary circumstances the interest that had been aroused would have been sufficient to assure it a ready market at a satisfactory price. Unfortunately, however, the outbreak of the war and the resulting unfavorable financial conditions upset these calculations, for there appeared in the *Wall Street Journal* of October 15, 1914, the following inconspicuous item:

The Sterling Gum Company syndicate scheduled to dissolve on September 15, has been extended to June 15 next. Notices to this effect will be sent out in a few days. This syndicate underwrote \$2,000,000 of the Sterling Gum Company stock.

Limitations of Sale Through Stock Exchanges

On the basis of the brief descriptions above given, it is apparent that floating new issues exclusively through stock exchange operations is a somewhat uncertain process, and moreover is suitable only for securities of a distinctly speculative character. The expense and risk of floating a comparatively small issue by this method are seldom justified.

Just how expensive an operation of this character is likely to prove is a question that cannot be satisfactorily answered. It is evident, however, that even though it may be completely and quickly successful, there must be a large outlay for brokerage commissions alone. The buying and selling transactions must total a great many times the nominal value of the issue which is being floated, and a commission of $\frac{1}{8}\%$ on each transaction may easily amount to a considerable sum. In addition, the risk undertaken by the underwriting syndicate must necessarily be offset by the possibility of earning a large profit. On the whole, it is questionable whether the average expense of selling by this method is any less than by the other methods that have been described.

It does not follow, however, that every new security which is listed on the stock exchange and immediately becomes active is in process of flotation through stock exchange manipulation. It is often the case that the security is listed simply as an incident to its flotation, and is allowed practically to take its own course except for receiving some support from time to time in case its price tends to sag below the direct "over the counter" price. In this case the fact that the security is listed, and that its quoted price is slightly above the "over the counter" price, is a powerful and legitimate aid in selling the security. There can be no question but that any security which enjoys the advantage of being listed and of having a regular market is, for that very reason, worth more than a security of equally high intrinsic value which is not so readily marketable.

It should be mentioned in this connection, that the faulty banking system which existed in the United States prior to the inauguration of the Federal Reserve Act in November, 1914, tended to concentrate call loan money in the New York market and thereby fostered speculation on the New York Stock Exchange. The result was an overconcentration of interests on a limited number of large and highly speculative issues, to the detriment of other issues. On the London and other stock exchanges this tendency is not so prominent; on the contrary, vast numbers of securities issued by governments and corporations in all quarters of the world are dealt in, and the interest of the purchasing public is spread with some degree of uniformity over the whole list.

It is greatly to be hoped that under the new banking system in this country a similar decentralization of call loan money and of speculative interest will take place. If this proves to be the case the great gambling operations in speculative issues will become a less prominent feature of the stock markets and the volume of actual buying and selling will

proportionately increase. This tendency will favor many of the smaller stock exchanges of the country, and especially will tend to favor the smaller corporations which have previously been unable to secure for themselves the attention that their securities deserve.

CHAPTER XV

UNDERWRITING

Origin of Underwriting

The practice of underwriting security issues has been referred to from time to time in previous chapters. It has been assumed that every reader is acquainted in a general way with the meaning of the term, but a more detailed discussion is presented in the present chapter.

The practice of underwriting arose in connection with shipping ventures during the seventeenth century. The leading ship merchants of London were accustomed to assembling in Lloyd's Coffee House to transact their mutual business. In the course of time, the custom arose of dividing the risk of venturesome voyages among a number of different merchants, each one agreeing to stand a fixed share of the loss or to receive a proportionate share of the profits. The contract to this effect was passed about and each merchant who agreed to it wrote his name under the contract—hence the word “underwriting.” As is well known, the term is used chiefly in relation to the distribution of insurance risks; though when applied to bond and share issues the essential thought is the same, namely that of distributing the risk.

Perhaps it would be more correct to say that the underwriting contract generally relieves the corporation which issues the security of all risk. As will be explained a little later, there are a number of different types of underwriting agreements, but they all possess the feature that a banking house or a group of banking houses undertakes that the corporation receive not less than an agreed sum for the whole issue within a fixed period. The underwriters obligate themselves to take

over the issue themselves in case it cannot be sold to the public above the agreed price.

Importance of Underwriting in Present-Day Financing

The advantages of this arrangement to a corporation are well worth a considerable sum of money. In the first place, an issue once underwritten is an assured success. The corporation may at once proceed with whatever projects the fresh capital is designed to finance. There is no tedious and costly period of waiting during which the securities are in process of being sold. Many new enterprises are of such a nature that time is an important element in making them successful. If, for example, a new plant is being built in order to handle certain contracts, or if an effort is being made to forestall competition, it might be fatal to the project if its inception were delayed until after all the stock or bonds have been sold.

A second highly important advantage is that underwriting assures success in raising the entire sum called for. Frequently any amount less than the entire sum would be a burden rather than a source of strength to the corporation. For example, a company operating department stores intends to establish a new store on a large scale in another city. The stores previously owned are developed as far as can profitably be done. To establish the proposed new store with insufficient capital would be merely to make it second-rate and to invite quick failure.

Let us suppose that the company, which needs \$1,000,000 for the new store, authorizes an issue of additional stock for that amount, and sells only one-half the stock, thus raising \$500,000. It is then in a position where it can go neither forward nor backward. It cannot very well return the money which has been raised, nor can it proceed with the upbuilding of the new store. It is possible, in a case of this kind, to take subscriptions to the new issue, the subscription agreement pro-

viding that it shall not be binding unless the complete issue is subscribed for within a given period. However, this introduces an element of uncertainty that interferes with effecting the sale of the security issue. Underwriting protects the corporation against all risk and difficulty of this nature. It can be certain of receiving the amount of capital that is agreed upon within a definite period.

Incidentally, the underwriting agreement carries with it the advantages that go with all other arrangements whereby a banking house agrees to market the securities of a corporation. The corporation gets the benefit of the specialized experience and judgment of the bankers, and thus the risk of making a serious error in the form or in the price of the new security is reduced to a minimum.

Not only is the underwriting agreement advantageous to the corporation, but also to the purchasers of the security issue. In the first place, the fact that an underwriting syndicate has been formed—provided it is made up of first-class houses—is in the nature of a guarantee that the security is sound. A still greater advantage is the insurance of the purchaser of the security against the same contingencies which would be harmful to the corporation; for it must be borne in mind that the moment the purchaser becomes a stockholder or a bondholder in the corporation, he begins to share in its good or evil fortunes. If the corporation, therefore, is injured by dragging out the sale of a new security issue over a long period, or by bringing out a security issue which finally is not entirely disposed of, the purchaser of the securities is one of the sufferers. It is, therefore, to his advantage that the issue should be underwritten and its success thereby assured.

The Underwriting Syndicate

We have seen that originally underwriting consisted in the distribution of the risk among several different merchants.

This remains a characteristic feature of present-day financial underwriting. It is true that the term is frequently applied to an agreement between a corporation and a single banking house, under which the banking house agrees to take over a block of securities at a given price. A transaction of this type may better be called a sale—or, at any rate, a contract of sale—rather than an underwriting. However, an arrangement of this kind, in which only one banking house is involved, is practically unknown except to cover issues of small size. A foreign government loan of as much as \$6,000,000 was recently “swallowed”—to use the bankers’ own term—by a single banking house; but ordinarily only issues of less than \$2,000,000 to \$3,000,000 are taken up by an individual house.

Usually, however, the original agreement is made between the corporation and a single banking house, and the banking house afterwards distributes proportions of the risk and profits among other banking houses. All these houses, working together, thus form themselves into the underwriting syndicate. Most of the larger banks and financial houses in the chief centres make it their practice to work in harmony with each other. The organization of the syndicate and the terms of the syndicate agreement will be taken up a little later.

There are two reasons which make it preferable for a banking house to join a considerable number of syndicates rather than to put through a smaller number of transactions in which it assumes for itself all of the risk and all of the profits. The first and obvious reason is in order to minimize risk. A false step in a syndicate—even though the syndicate should fail ultimately—would not prove ruinous; whereas the failure of a good-sized issue in which only one house was concerned might not only tie up enough capital to wreck the house, but might also wreck its reputation, which is an asset of even greater importance. The second motive for preferring syndicate participation is that it enables the bond and brokerage

houses to offer to their customers a well-diversified list of securities. The general retail security merchant should be prepared to deliver to a customer any kind of security the customer may fancy, just as the department store is ready to sell anything from pins to locomotives.

Community of Interest Among Underwriting Houses

If one banking house closes a good contract with an excellent chance of profits, others are usually invited to come in as members of the underwriting syndicate to handle the contract. In this way all of them more or less take part in all the important underwritings. There is, of course, no formal agreement to this effect but it is tacitly understood that when one house permits its neighbor and rival to join in a profitable underwriting, the favor is to be returned at the first opportunity. So well-understood is this arrangement, that frequently—in the Wall Street district at least, and probably in other centres—the firms which become members of an underwriting syndicate are scarcely consulted. The banking house which has made the agreement with the corporation and which is managing the syndicate, simply distributes the issue as it thinks best and notifies each of the participants making up the syndicate. Most of these somewhat peremptory invitations are profitable, and it is safe to say that invitations of this kind from one of the three or four most important banking houses are seldom, if ever, refused. In testifying during the insurance investigation some years ago, J. P. Morgan, the elder, explained that some highly important syndicates involving tens of millions of dollars were organized by his firm through the simple process of calling up the selected list of participating houses on the telephone and advising how much each was expected to subscribe.

An important result of this "community of interest" arrangement is that it removes the occasion for keen competition

among the leading banking houses. It is comparatively of minor importance whether one house or another carries through the negotiations with the issuing corporation and becomes the active manager of the syndicate, because in any case each of the important houses will participate in the syndicate and in a fair share of the profits.

In New York it is well understood that negotiations for the flotation of an issue of any size should be taken up with only one of the important banking houses at a time. In case negotiations with one house fail definitely, they may possibly be taken up with another house. But the important banking houses will not directly compete with each other; nor will one of them even interfere with suggestions or investigations while another has the matter in hand. No doubt much the same kind of a tacit understanding exists in most financial centres. Many business men who are accustomed to dealing under highly competitive conditions resent the existence of this invisible and indefinite bond union among the large underwriting houses. If they are bringing an issue into the market to be sold, naturally they would like to have it eagerly bid for. They are looking for competition and they find a silent, but inflexible, understanding. Much of the outcry of the last few years against the so-called "money trust" is an expression of this resentment.

The bankers, on the other side, claim first of all that unchecked competition would be disastrous not only to them, but also to the whole business community which they serve. It would invariably mean reckless extension of credit, over-financing, and disregard of conservative principles. They advance the claim, further, that they make no oppressive terms or restrictions and that the present situation leaves room for difference of opinion, thus preventing the establishment of a complete monopoly. Finally, they assert that the relations between the financial managers of a corporation and the bank-

ing house which handles the security issue ought to be of intimate, permanent, and semi-professional nature. A corporate official ought to pick out a banker in whom he has implicit confidence, just as he picks out a physician or a lawyer in whom he has confidence, and ought to stick to the man or the firm he has picked out until that confidence is shaken or there is some real reason for disagreement. In that case, he should cut off all relations as quickly as possible and entrust his financial affairs to some other banking house. In other words, the banker feels that he is rendering a personal and partly professional service rather than merely buying and reselling a certain commodity.

Syndicate Agreements

There are four distinct types of agreements between an underwriting syndicate and the corporation which puts out the underwritten issue. Possibly other variations from these basic types could be found.

1. The corporation may itself sell the issue and the syndicate may simply insure that the whole issue will be disposed of within a given time at a minimum price. The corporation, we will say, is bringing out an issue of \$1,000,000 6% bonds, which it offers at par. The underwriting syndicate may agree that it will take any bonds left unsold at the end of the year at a special price of 90. The syndicate would receive a commission of 2 to 5% for making this agreement. If the issue were successfully sold, the syndicate would merely collect and distribute its commission and dissolve. If the issue at the agreed price were unsuccessful, the syndicate would take over the unsold balance and dispose of it. This type of agreement is now uncommon except when a corporation has given a subscription privilege to its own shareholders but is apprehensive that the offer will not be taken up in full.

2. A banking house may conclude an arrangement with a

corporation to handle the sale of a block of securities and may afterward call in other banking houses to take over certain proportions of the risk and of the profits. The corporation, however, has no dealings with the syndicate, as such, but only with the original underwriter which becomes the manager of the syndicate.

3. The syndicate may be formed before a final agreement with the corporation is signed, and the agreement may be directly between the corporation and the syndicate, though the management of the whole transaction and the actual selling of the securities may be left in the hands of the one banking house which has taken the initiative. This banking house carries through the sale of securities and does not distribute them to the other members of the syndicate unless the sale is in whole or in part unsuccessful.

4. The agreement is made between the syndicate as a whole and the issuing corporation and the securities are at once distributed among the members of the syndicate in proportion to their participations. This form of underwriting is almost in the nature of a joint purchase, each of the banking houses being expected to act independently in disposing of its proportion of the issue. This is perhaps the most common and most useful type of agreement for handling large issues.

It is clear, from the brief descriptions above given that the term "underwriting" is used in a loose sense. It is, in fact, often difficult to distinguish in practice between underwriting a block of securities and purchasing a block of securities. Even when a single banking house takes over outright the complete security issue and pays to the corporation the agreed price for this issue, the transaction is commonly referred to as "underwriting."

Whatever the type of syndicate issue may be, there is always this common characteristic: that the active management is unreservedly in the hands of the banking house which

organized the syndicate. In the published agreement, for example, of the syndicate which underwrote the retirement of United States Steel Corporation preferred stock in 1902, it is provided that:

J. P. Morgan and Company shall be sole managers of the syndicate, and in behalf of the syndicate they may make any and all arrangements, and may perform any and all acts, even though not herein provided for, in their opinion necessary or expedient to carrying out the provisions of this agreement; or to promote or to protect what they deem to be the best interests of the syndicate. The enumeration of specific powers in this or any other article of this agreement, shall not be construed as in any way abridging the general powers of this article intended to be conferred upon or reserved to J. P. Morgan and Company.

Throughout the agreement other reservations of the same general character abound, and in this respect the contract is typical of most underwriting syndicate agreements.

In return for its special efforts the managing house usually receives a commission as manager, which is deducted from the syndicate profits before distribution of the remaining profits is made among all the members of the syndicate. This payment to the managing house varies a great deal, depending on the profitableness of the transaction. It will probably average 1 to 2% on the par value of the block of securities.

It is very rarely the case that these syndicate agreements, no matter how informal they may be, give rise to serious misunderstanding or litigation. This is, no doubt, due primarily to the high standards of commercial honor which prevail among the bankers who are active in underwriting syndicates. One of the rare instances of litigation arose in connection with the syndicate formed to underwrite the bonds issued at the organization of the Mount Vernon-Woodberry Cotton Duck Company. This syndicate was managed by the Continental

Trust Company of Baltimore. Two New York banks, the Merchants Trust Company and the Central National Bank, each of which had subscribed \$300,000, sued the Continental Trust Company in the United States District Court for the return of their subscription. They alleged fraud and misstatements. They claimed that the mills were not worth what they were represented to be and were not earning what had been stated; further, they claimed that the Continental Trust Company, through its ownership of \$1,000,000 of income bonds, had been especially favored under the terms of exchange that had been agreed to in forming the combination. The case was never brought to trial and was finally settled out of court.*

The commissions of underwriting syndicates may vary all the way from $1\frac{1}{2}\%$ to 10%, or even more. If the commissions are high, it is quite the custom to make them payable partly in securities. In 1910, for example, the newly organized International Cotton Mills Corporation was in need of working capital, which it secured by selling to Blair and Company \$2,000,000 6% five-year notes at par, in consideration of a commission of \$1,000,000 par value of the corporation's common stock. These notes were offered to the public by Blair and Company at 98. In 1898 the Union Pacific Railroad Company paid a syndicate \$5,000,000 of preferred stock, then quoted at 59, for underwriting a subscribed capital of \$15,000,000. This amounted to a commission of 19%.† These examples, of course, refer to companies which at the time did not have a high credit standing, and are not to be taken as typical.

Speculative Underwriting

Most of the preceding remarks in this chapter refer to the underwriting of high-grade bond and preferred stock

*Dewing's "Corporate Promotions and Reorganizations," p. 350.

†Stuart Daggett's "Railroad Reorganizations," pp. 347, 348.

issues by financial houses of the highest standing. However, this is by no means the only situation in which underwriting is frequently advisable. In addition to assuring success in disposing of large blocks of securities for established corporations, syndicates may be formed for the purpose of underwriting the issues of new or of reorganized corporations.

In any of these three cases the issue that is being brought out may be of a speculative character and the syndicate itself may be far less stable and more speculative than has been assumed in what has been said above. Frequently underwriting syndicates are made up, not of first-class banks or banking houses, but in whole or in part of individuals and of second-rate houses. Sometimes even the best houses are led into mistakes which may cause financial loss and in addition prove harmful to their reputation.

At the time the United States Realty and Construction Company was organized, the large working capital which was thought to be necessary for the company was obtained through a syndicate. \$11,000,000 was subscribed to this syndicate. The members paid in 20% of their subscription in cash, gave their notes for 60%, and the bank advanced the remaining 20% on the syndicate account. The syndicate received \$100 in preferred stock and \$100 in common stock for each \$100 in cash which it furnished. The subscribers included some of the strongest concerns in New York. The managers received as their compensation \$220,000, or 2% of the subscriptions to the syndicate.

On the basis of the first quotations for the shares of the United States Realty and Construction Company, the syndicate had a paper profit of a little less than one million dollars. Although the company had the support of the strongest interests, its securities immediately began to decline in market value and by the end of six months it still had on hand a large proportion of preferred and common stocks which it had re-

ceived and which, at current quotations, could be sold only at a heavy loss.

On September 11, 1903, the syndicate was dissolved. The managers of the syndicate had originally acquired 110,000 shares of preferred and 110,000 shares of common. Soon after organization the managers sold 67,000 shares of common at \$37.50 and refused an offer of \$35 a share for the remaining 43,000 shares. They used a large part of the proceeds in purchasing 27,000 shares of common and 17,000 shares of preferred at prices much less than they had originally paid.

At its dissolution, after the managers had taken \$220,000 for their services, the syndicate was in possession of 127,000 shares of preferred, 77,000 shares of common, and \$675,000 in cash. Approximately \$500,000 of the cash had been received from dividends on the preferred stock. On the date of dissolution the preferred stock was quoted at \$36 a share and the common stock at \$6.50 a share. Each member of the syndicate received for each \$1,000 contributed, \$1,155 in preferred stock, \$702 in common stock, and \$61.66 in money, of which \$45 was furnished by dividends on the preferred stock held by the syndicate. Eliminating this \$45, and figuring the shares at their market values, each member of the syndicate got back less than one-half of the amount he had contributed. Furthermore, a week after the dissolution of the syndicate, the fourth dividend on the preferred stock was passed and the stock went to yet lower levels.*

Dewing cites, also, another instance of even more disastrous failure. At the time of the incorporation of the United States Shipbuilding Company in 1902, the promoters were required to sell enough first mortgage bonds between June 14 and August 11 to have in hand \$7,500,000 cash by the latter date. However, the public offering of the bonds was a failure, inasmuch as only \$500,000 out of the total offering of \$9,000,-

*Dewing's "Corporate Promotions and Reorganizations," pp. 233, 235, 238.

ooo was subscribed for. The promoters therefore fell back upon their French and American underwritings of the bonds.

Here ensued a very amusing correspondence by cable between the promoters and the French underwriters, most of whom were not bankers but individuals untrained in business affairs. The Frenchmen declined to meet their alleged obligations. They asserted that the promoter had assured them that their underwritings would never be called and had later cabled them that the public offering of the bonds was a success.

The American underwriters, who were better accustomed to such transactions, took their medicine and accepted about \$4,500,000 of the bonds at 90. The promoter, John W. Young, went to Paris in a strenuous but unavailing attempt to secure payment from the French underwriters.

In the meantime, Mr. Dresser negotiated, with the assistance of Mr. Schwab and J. P. Morgan and Company, loans of about \$2,500,000 under personal indorsement of himself and Mr. Nixon, on the credit of the Trust Company of the Republic, and on the basis of the French underwriting. When the French underwriters still refused to take up their share of the bonds, the results were disastrous for the promoters.*

Still another example is illuminating. In 1910 it became evident that the Consolidated Cotton Duck Company was in need of a considerable amount of new capital, both for the acquisition of additional properties and for investment in its own mills. It was determined that it would be advisable to secure a majority of the stock for a group of Bostonians, who desired to become active in the company. Three syndicates were formed as follows:

May 27, 1910, in order to acquire 53% of the Consolidated Company's stock and a supply of between two million and three million dollars working capital.

*Dewing's "Corporate Promotions and Reorganizations," pp. 489, 490.

April 17, 1911, in order to purchase common stock only of the new company.

April 27, 1911, to acquire a minority of Consolidated stock and supply \$500,000 new money.

On May 27, 1910, Augustus P. Loring, a Boston lawyer, and Joseph B. Crocker, a stock broker, were made syndicate managers. Each man received \$12,500 in compensation for his services, in addition to which Mr. Loring received a fee for his legal services in connection with the incorporation of the new company. Much of the work of organizing the syndicate and of carrying through the reorganization of the company was taken care of by Samuel Untermeyer, who also used his influence to secure banking connections for the company.

The syndicate agreement of May 27, which was marked "confidential," contained the following provisions:

1. The new International Company was to issue 52,875 shares of preferred and 45,375 shares of common to the managers of the syndicate.
2. The syndicate was to acquire 61,000 shares of preferred and 71,000 shares of common of the Consolidated Cotton Duck Company (\$50 par value).
3. The syndicate was to purchase the preferred and common stock of the International for \$5,093,000, which the subscribers were to take in the proportion of ten shares of preferred and ten shares of common, for each \$1,000 of their subscription.
4. The managers were authorized to sell the excess of 1,945 of preferred stock and to purchase enough common stock to make their holdings of both kinds of stock 50,930 shares.

The Loring-Crocker syndicate of the International Cotton Mills Corporation was unfortunate in its operation. Syn-

dicate subscribers were allotted \$100 in preferred and \$100 in common stock, for each \$100 cash. Three years later, in the reorganization, the old preferred stock was given \$77 in new common stock of the new International, and the old common stock was given \$16.33 in new common. For each \$100 cash put in by a syndicate subscriber, therefore, he received, in 1913, \$93.33 in new common stock, worth about \$30 a share on the open market. For each \$100 put in, the syndicate subscriber received after three years \$28. This was not due to failure of the company but rather to miscalculation at the beginning as to the amount of fresh capital that would be required in order to rehabilitate the property of the company. *

It would be difficult to give any detailed information concerning the inner workings of these speculative syndicates. Their operations have not been in any sense standardized. Each syndicate formed for speculative purposes drives its own bargain. Inasmuch as its compensation ordinarily comes in the form of securities rather than of cash commission, its risk is large and it is generally entitled to a correspondingly large block of stock. The operations of a syndicate of this character in connection with the promotion of a new corporation are really a part of the work of promotion and have been referred to under that head. We shall have occasion in a later chapter to refer to the activities of underwriting syndicates in connection with reorganizations.

*Dewing's "Corporate Promotions and Reorganizations," pp. 382, 403.

Part IV—Internal Financial Management

CHAPTER XVI

INVESTMENT OF CAPITAL FUNDS

Estimating Capital Requirements

Having organized a corporation, issued the proper securities, carried through the process of promotion, and disposed of the securities, what is to be done with the capital that has thus been secured?

Presumably this question will have been answered before the financial plan was formulated; that is to say, the amount of capital that would be required was first of all estimated and the financial plan was made to fit this estimate. Right here is a frequent source of serious error. The capital required is often not estimated at its proper amount. It is easy enough, usually, to calculate what will be needed for plant and machinery, road-bed and equipment, office furniture, or whatever the fixed assets of the business may be. In addition, however, there are two requirements of uncertain amount—for working capital and development expenses.

Sufficient working capital must be provided in order to take care of the normal process of purchasing raw materials and supplies, turning out finished products, selling the products, and waiting for payments to be made. If the original estimates of working capital are insufficient, some emergency measures must be resorted to or the business will come to a dead stop.

The losses and expenses of development are generally underestimated. Every new organization must be in part an

experiment. Men will be employed who are unsuited for their positions; methods of production and of sale will be tried that must be discarded; machinery will be installed that proves worthless; advertisements and sales booklets will be written that do harm rather than good. If the enterprise is basically sound, all these expensive losses may properly be charged as a part of the initial expense of getting the business on its feet. The experience of generations has proved that mistakes of this kind are unavoidable and they should be provided for in the original estimates of capital expenditures.

These remarks apply—though with somewhat less force—to the planning of extensions and betterments for which fresh capital is raised. It is an every-day occurrence for a manufacturer to plan to put up a new building and install new machinery that will increase his capacity, let us say, 50%, and to overlook entirely the necessity for a corresponding 50% increase in his working capital. Also, he frequently overlooks the probability of experiments and losses in construction of the plant and in developing the sales and administrative organization which will take care of the increased output.

Fixed Capital and Working Capital

The distinction between fixed capital and working capital is often not clearly understood. There would be much less confusion if it were possible to drop the adjective “working,” which in this connection is meaningless, and substitute the word “revolving.” “Fixed” capital and “revolving” capital are almost self-explanatory. The “fixed” capital is invested in the plant, equipment, and other forms which cannot be disposed of without breaking up the business. The “revolving” capital is invested in raw materials, in stocks of partly finished and finished products, in accounts receivable, in salable securities, and in cash. Capital in all these forms is constantly being converted—after whatever alterations in form are

necessary—into cash, and this cash flows out again in exchange for other forms of working capital. Thus, it is constantly revolving; or, to use a more common expression, it is being “turned over.”

Note that it is said in the preceding paragraph that the working capital is invested in cash or in various forms of assets that are readily convertible into cash. This is not equivalent, however, to saying that the total value of the cash or cashable assets measures the amount of the working capital. On the other side of the balance sheet, there is a group of liabilities, consisting chiefly of short-time bank loans and accounts payable, which must be deducted from the total of the working assets in order to determine the net working capital. If this were not done, a firm which had managed to pile up a great quantity of merchandise debts, might be considered, looking only at its assets, to be well provided with working capital; yet the truth might be that it had little or no surplus of working capital above its current liabilities.

Mention is frequently made of “quick assets” and “quick liabilities,” and the question is sometimes raised as to the distinction between them and “working” or “current” assets and liabilities. As a matter of fact, there is no clear-cut or authoritative distinction. In a general sense, however, the adjective “quick,” used in this connection, is reserved for assets or liabilities that have only a short period—say 30 days or less—to run. A stock of finished products which are regarded as immediately salable might be listed as a quick asset, whereas a stock of half-finished products or of raw materials could not be described as more than a “working” or “current” asset.

Necessity for Adequate Working Capital

The history of the Westinghouse Electric and Manufacturing Company offers some of the clearest and most striking illustrations of the necessity of using care in the investment

of capital funds, and especially of the advisability of keeping on hand an ample supply of working capital. The illustrations are especially apt, because this company has always carried on an extensive and profitable business and, so far as industrial processes go, has been conspicuously well managed. Yet it became financially embarrassed in 1890, and again in 1907, both embarrassments being the direct result of rapid expansion of business, leading to a large investment in fixed assets and a relative diminution of working assets.

When it was realized by the officers of the company in 1890, that the steady growth of the business was leading to a dangerous financial situation and larger and larger current obligations which could not be met were piling up, it was decided, as an emergency measure to increase the stock from \$5,000,000 to \$10,000,000 and to offer the additional \$5,000,000 to previous shareholders at the bargain price of \$40 a share. Radical proposals of this kind, being obviously intended to relieve pressing demands, naturally arouse distrust. The net amount realized by the company from this sale was only about \$1,400,000, which was not enough to create an adequate working capital. In fact, the situation rapidly became worse. In the summer of 1890 the company had outstanding about \$2,000,000 of notes covering merchandise purchases and bank loans. By the early part of 1891 the floating debt had become \$3,300,000. A financial reorganization, with its attendant frictions and losses, was then recognized as inevitable.

After the reorganization of 1891 the company continued to expand its business and as a result continued to meet serious financial problems. These problems were not wholly the outgrowth of internal development, but were in part a necessary feature of the electrical industry as a whole. The progress of electrical invention required continual and extensive investment of capital for generating stations, transmission lines,

and electrical machinery. Throughout the country small lighting, power, and traction companies were endeavoring to sell their securities, frequently without much success. Yet, it was evident that their projects in most cases were sound and it seemed to be necessary for the Westinghouse Company, in order to keep up and develop its sales, to assume a portion of the burden of financing its customers. This it did by accepting in payment for equipment the notes of these local companies, generally secured by a deposit of their bonds and stocks as collateral. The Westinghouse Company then relied on discounting these notes, which in normal times could readily be arranged for. At periods of credit restriction, however, the notes became unmarketable and the Westinghouse Company itself was hard pressed for funds with which to meet its own obligations.

Between 1891 and 1907, this growing problem was successfully solved by repeated sales of capital stock. In 1896 the authorized capital was increased from \$10,000,000 to \$15,000,000, and in 1901 from \$15,000,000 to \$25,000,000. At the same time, the company was putting out several million dollars of collateral and debenture bonds. Nevertheless, notes payable grew steadily until they aggregated \$5,000,000 in 1901, and \$14,000,000 in 1905.

Dewing has calculated this company's ratio of current liabilities to current assets, of current assets to total assets, and of current liabilities to total liabilities, for a number of years, as follows:*

	Current Liabilities to Current Assets	Current Assets to Total Assets	Current Liabilities to Total Liabilities
Feb. 29, 1892	46%	12%	6%
Mar. 31, 1894	22%	34%	8%
Mar. 31, 1897	106%	11%	12%
Mar. 31, 1901	83%	25%	21%

*Dewing's "Corporate Promotions and Reorganizations," pp. 165, 200.

Mar. 31, 1902	71%	27%	19%
Mar. 31, 1903	88%	26%	23%
Mar. 31, 1904	101%	22%	23%
Mar. 31, 1905	163%	18%	29%
Mar. 31, 1906	66%	22%	14%
Mar. 31, 1907	96%	16%	15%
Oct. 31, 1907	86%	20%	17%

When the company was finally compelled in 1907 to confess its inability to meet current obligations and a receiver was appointed, it was at once agreed on all sides that the prime cause of the failure was the lack of sufficient working capital.

There were, however, some differences of opinion as to the extent of the remedy that should be applied. The creditors were inclined to demand not only an immediate relief, but a radical change of financial policy. Mr. Westinghouse, on the other hand, did not believe that there was anything fundamentally wrong with the previous financial policy of the company and sought only to extricate it from its immediate entanglement. It was finally agreed in the interest of the creditors and of all those who were disposed to insist upon sound financing, that a new management should take the reins.

There are not many instances of large enterprises where miscalculation and recklessness in financial affairs were combined with so much unquestioned ability in handling mechanical and industrial affairs as in the case of the Westinghouse Company. Most large and successful companies have a better-balanced management. In small corporations, however, almost the same situation is frequently found. The proprietor and manager of a business, through his personal energy and resourcefulness, makes it move ahead and earn good profits. To take care of his increasing business he extends his plant or builds up his store or in some other form enlarges his fixed capital investment and fixed expenses. Thereupon he suddenly wakes up to the surprising fact that, on account

of his prosperity he is pressed harder and harder for funds. Unless there is a sudden change in his methods, it is more than likely that he will drive rapidly ahead into bankruptcy. A sad and constantly recurring spectacle in business life is that of a strong man beaten into failure through his own energy and ability in producing and selling.

Some Factors That Affect Working Capital

How is it possible to calculate in advance how much working capital will be required, and thus keep on the safe side in providing capital funds? It is not possible to give an exact formula for answering this question, but an approximate answer in any given case may be reached.

First of all, it is clear that the proportion of working capital in some lines of business is far greater than in other lines. This may be illustrated by two extreme cases. Telephone companies necessarily have large sums invested in wiring, poles, central offices, and other equipment, but after a complete telephone plant has been installed in a community the running expenses consist simply in maintenance and in the salaries of officers and employees and are comparatively light. It is the custom for telephone companies to render bills for their services once a month in advance; consequently, all the money which is required for running expenses from month to month is provided before the expenses are really incurred. Evidently there is no necessity in this instance for working capital, because the current receipts may safely be depended upon to take care of the current outgo.

On the other hand, let us take a retail store which occupies rented quarters. The only fixed assets required will consist of store furniture and equipment; all the other assets, including the stocks of merchandise, the accounts receivable, and the cash, are "current" or "working." The greater portion of the capital that must be invested in such an enterprise, will consist

of working capital. This is true of practically all trading enterprises, and is particularly true of financial enterprises. Banks must keep all, or nearly all, of their assets in such a form as to be converted into cash almost at a moment's notice.

We may consider, therefore, as the first factor which determines the requirements of working capital, *the general nature of the business*. If the business consists merely of leasing real estate, providing facilities for transportation, and the like, all or nearly all of the investment will be in fixed forms. If the business is manufacturing, then a relatively small proportion will consist of working capital. If it is trading or financing, the chief requirement will be for working capital.

A second factor obviously is *the volume of business*. Generally speaking, the necessity for working capital—except in the first class of business above mentioned—will vary in proportion to the volume of sales. However, this statement assumes that the other factors mentioned below are uniform in their operation. Making the assumption that methods, expenses, and terms of buying and selling goods and of producing the goods are standardized, then we may safely say that a 50% increase in output and sales will necessitate a proportionate increase in working capital.

But these general remarks as to the nature and volume of business are serviceable chiefly in forestalling any misunderstanding of what follows.

The practical considerations that require thought and are helpful in making estimates of working capital are:

1. Length of period of manufacture.
2. Turnover.
3. Terms of sale.
4. Terms of purchase.
5. Facilities for converting working assets into cash.
6. Seasonal variations in business.

The process of making proper allowances for all these factors and of calculating in advance the volume of working capital that will be needed is of so much importance that a separate chapter is devoted to this subject (Chapter XVII).

Figuring Fixed Capital Requirements

It has been noted above that it is comparatively easy to calculate, before an enterprise is started, how much of an investment will be required in order to provide plant, machinery, and other fixed capital. This statement is true, assuming that the enterprise is simple and unified, and that the promoters and managers know exactly what they intend to do.

Unfortunately this last condition does not always exist. It is a common occurrence to find that a company which was started to manufacture a given line of goods, gradually engages in the manufacture of something entirely different. Or it may continue to manufacture a given line but discover that some new process is required. Again, after a company has once developed its own special business successfully, its managers almost invariably begin to thirst for fresh conquests and begin to take on "side lines." Or, yet again, the managers of a company which has proved successful may decide to make use of the surplus that is accumulating for their own purposes instead of distributing it to the stockholders, and may build up a large account under the head of "investments."

In figuring the requirements for fixed capital, therefore, we have to consider not only the original plant and equipment which must be obtained in order to bring the business into existence, but also later acquisitions or developments along any one of the following lines :

1. Extensions of the original plant.
2. Increases or changes in equipment.
3. Adoption of side lines.
4. Outside investments.

It is in connection with subsequent changes or developments along these lines that most of the opportunities for mistakes and miscalculations in the investment of capital in fixed forms arise.

Investing Capital in Extensions

One of the most curious instances on record of a disastrous investment on the part of a corporation in extending its own business, is that of the Assets Realization Company. This company was organized for the specific purpose of giving financial relief to embarrassed concerns, by taking over the assets which they could not otherwise dispose of. It is frequently possible to purchase from such concerns plants, machinery, securities, and other assets of great value, at bargain prices. It was the expectation of the organizers of the Assets Realization Company that they could take their choice among properties thrown on the market in this way, and could rehabilitate them or adapt them to other uses or see to it that they were managed in a more efficient manner, and in this way realize large profits for themselves. The plan seemed fundamentally sound, and for some years the Assets Realization Company was successful. As it proceeded, however, the company gradually extended its operations into the underwriting of securities of new corporations, which for one reason or another could not be marketed. Furthermore, it is stated that some of the assets which had been taken over from insolvent corporations could neither be utilized nor resold, and remained as a dead weight on their hands. Eventually the company became afflicted with the same disease which it had undertaken to cure, and was itself so loaded down with unrealizable assets that it was compelled in 1914 to go into the hands of receivers. It had extended its business beyond the limits of prudence.

Another instance of unwise extension was the purchase by the United States Cordage Company in 1894, of a binder twine

mill from the McCormick Harvesting Machinery Company for \$900,000, of which \$500,000 was paid in cash. At the same time that the company was paying out \$500,000 for this mill, it was borrowing \$500,000 in order to meet interest payments for its funded debt. The new mill could not at once become a dividend payer, but rather called for additional investment. Therefore it is not surprising that within a short time the United States Cordage Company found itself in financial difficulties.

Shortly after the formation of the Consolidated Cotton Duck Company in 1905, it was decided to purchase the H. Spencer Turner Company, which was the chief selling agent for the products of the Consolidated Company. The arrangement increased the funded debt of the Consolidated Company by about \$1,500,000, which was its total investment in this extension of its business. The chief assets of the Turner Company consisted of its good-will and trade connections acquired in handling the Consolidated Company's own trade marks and brands. Instead of assisting in the marketing of the company's products, the move really stimulated competition, inasmuch as other selling agents, fearing that their independence might be threatened, began to establish duck mills of their own.

Many large corporations have been led astray by the idea that it was necessary for them to extend their business by attempting to buy up all competitors. The chief result has been that they have "held the bag" for all kinds of trouble-making schemes. The contrary policy is ably set forth by Chairman A. W. Green in the annual report of the National Biscuit Company for 1901. Mr. Green says:

When the Company started it was believed that we must control competition, and to do this we must either fight it or buy it. The first meant ruinous war of prices, the second constantly increasing capitalization. Experi-

ence soon proved to us that instead of bringing success, either of these courses, if persevered in, must bring disaster. This led us to ask ourselves whether the Company, to succeed, must not be managed like any other large mercantile business. We soon decided that within the Company itself we must look for success.

We turned our attention and bent our energies to improving the internal management, to getting the full benefit from purchasing our raw materials in large quantities, to economizing the expense of manufacture, to systematizing our selling department, and above all things to improving the quality of our goods. It became the settled policy of this Company to buy out no competition, and to that policy, since it was adopted, we have steadfastly adhered and expect to adhere to the end.

Another very common fallacy on the part of manufacturers is the notion that they must handle their own retail outlets, and to do so must build up a group of chain stores. This policy has, in fact, been successfully followed by many important companies, such as the George E. Keith Company, manufacturers of "Walk-Over" shoes, the Regal Shoe Company, a great many brewing companies, etc. In practically every such instance, however, it will be found that the policy has been followed as a means of protection, not as a profit-maker in itself. The dangers of extension along this line are not to be minimized. The manufacturer, in the first place, is going into a line of business with which he is not familiar and where it is difficult to avoid numerous pitfalls. In the second place, he is likely to find that the move brings him the active hostility of the retailers who have previously served as his agencies, thus making it necessary for him to develop his chain of stores more rapidly than he had anticipated and to invest more money than he had counted upon.

It is a fact often commented upon that successful corporations, as they expand, ordinarily tend to earn smaller and smaller returns on the actual value of their property. One

common explanation is that at the beginning one or two managers exercise close personal supervision over the whole enterprise, and direct it by their insight and wisdom into the most profitable channels; whereas later their duties are necessarily delegated in part to men of less ability. The economist offers in explanation the "Law of Diminishing Returns," which is simply the principle that the most advantageous opportunities for utilizing capital and energy are taken at the beginning, and the less advantageous opportunities are left for future development. Yet, neither one of these explanations applies in the case of many corporations which are ably managed and which continually raise and invest fresh capital without decreasing the average rate of return. Modern methods of organization and management and the advantage of being able to employ specialized talent go far toward offsetting the first difficulty above named. As to the economic principle, it applies, to be sure, but only after the industry has been so far developed that all its highly advantageous opportunities have been sought out and utilized; and that is a condition which obtains in very few lines of business. We may safely infer that one important cause for a decline in the rate of return is to be found in the strong tendency to make extensions of original businesses along lines that are not wisely chosen. The results of each move are not foreseen and calculated with sufficient care.

As an example of profitable extension on a great scale, we may take the case of the General Electric Company. During the nine years, 1905-1913, the capital stock increased from \$48,000,000 to \$101,000,000. However, \$23,000,000 of this increase represented a stock dividend in 1912 and another \$10,000,000 was due to conversion of debenture bonds, leaving only \$20,000,000, or slightly over 40%, as an actual increase of invested capital. During these nine years, the profits applicable to dividends doubled and the gross sales

nearly tripled. All this has been accomplished by steady progress in extending the business along lines that had previously been mapped out. It is an inspiring record of what may be accomplished by persistent and consistent effort.

Calculating the Extension of Capital for a Bank

The previous discussion in this chapter has been related chiefly to manufacturing and trading establishments. The same principles, however, apply to all lines of business. Not long ago the president of an important national bank had under consideration the advisability of increasing his capital stock from \$750,000 to \$1,000,000, but an analysis of the status of his bank and of customary practice in regard to banking capital indicated that the increase would be inadvisable for the reasons stated below.

The combined capital and surplus of this bank was found to bear a relation to the deposit liabilities of about 1 to 4. Other banks in the same city varied from as low as 1 to 3 to as high as 1 to 5.8. In the City of New York some of the large banks have proportions as follows:

American Exchange National Bank.....	1 to 5.5
First National Bank.....	1 " 9
Fourth National Bank.....	1 " 4
Hanover National Bank.....	1 " 6.6
Merchants National Bank.....	1 " 6.7
National Park Bank.....	1 " 6.7
National City Bank.....	1 " 3.7
National Bank of Commerce.....	1 " 4

Although some of these banks have a high proportion, it seems to have been the practice of at least two of them in recent years to increase their capital from time to time so that the proportion existing between the capital and surplus on the one side and deposit liabilities on the other side, would be about 1 to 4. This proportion is generally regarded

as about correct for a bank doing the ordinary type of commercial business, though there may, of course, be excellent reasons for either a higher or a smaller proportion in particular cases.

In the case under consideration the bank was said by its president to be carrying on the ordinary type of commercial business and to be earning reasonably good but not extraordinary profits. If a great many new accounts were to be taken over and the deposit liabilities were thus to be largely expanded, its present capital would probably not be enough to maintain a secondary reserve up to the full requirements of safety. Unless, and until, this expansion should take place, however, there seemed to be no necessary reason for increasing the capital so as to reduce the proportion of capital to surplus liabilities below the normal ratio.

There would still remain the question whether the increase in capital at this time would in itself be a factor tending to bring about a corresponding expansion of current discount and deposit business. On this point, the consensus of opinion seems to be in the negative. When the capital of a bank is not profitably occupied and is not earning a normal rate of profit, the directors and managers are immediately put under pressure to find employment for the idle funds. This they can accomplish either by making investments in securities and commercial paper, apart from the paper that comes to them from their own customers, or by entering into side-line activities, such as underwriting and the like. Neither course of action is advisable for a commercial bank. A third possible course, which in this case would not be given serious consideration, is that of soliciting the accounts of new and weak depositors.

On the whole, there is probably no substitute in the banking business for the slow and solid growth that naturally goes on after a bank has become well-established and is main-

taining an untarnished reputation for conservatism mixed with a reasonable degree of alertness. Expansion of that nature will gradually build up deposit liabilities until it becomes advisable to make a corresponding increase in capital. But the chief point to bear in mind is that the expansion will come first and the increase in capital will appear as a result, not a cause.

Investing Capital in Betterments

One of the frequent causes of embarrassment to corporations which take over going concerns, or which are formed in order to combine previously existing concerns, is the discovery that the supposed net earnings of the acquired concern have been achieved through failure to maintain the property in first-class condition. Of course, if the investigation has been sufficiently thorough, this fact will presumably have been discovered. However, the truth is that such investigations frequently are carried on in slipshod fashion, or may even be omitted altogether. Cases are not uncommon where important combinations have been formed on the strength of the unsupported statements of earnings submitted by each of the constituent companies.

When the International Cotton Mills Corporation was organized in 1910 to take over the mills of the old Mount Vernon-Woodberry Company and the Consolidated Cotton Duck Company, it appeared on the surface that sufficient new cash and working capital had been provided. It developed later, however, that the mills acquired were in a dilapidated condition and that much larger sums than had been anticipated were necessary in order to rehabilitate the property. Due to this weakness, the corporation got into difficulties, and a reorganization became necessary in 1913.

Even within a going and apparently successful corporation the same condition may exist. If the direction of affairs is

left wholly in the hands of the active officers they will not be over-anxious to disturb their showing of profits by setting aside ample sums to offset depreciation and to maintain the property at its full value. It must be borne in mind that making repairs from time to time is not enough. If competitors are installing new and more efficient machinery, it is not sufficient for the company to keep its old machinery in good repair. At some later date, when the fact becomes known that large amounts are urgently required to bring the property back into first-class condition, both the stockholders and the directors are likely to be loath to give up or even reduce their dividends to atone for the errors of the past. Instead, the idea of raising new capital to provide for betterments will meet with favor. It will be argued that betterments represent a capital expenditure which may properly be provided through the issuance of fresh securities, but the expenditures now accumulated in a lump should have been met out of profits over a series of years. It is also probable that fresh capital invested in bringing the plant and machinery up to a reasonable degree of efficiency will not materially increase the profits, but will merely have the effect of preserving and restoring the profits the concern has been earning.

The question as to when betterments constitute a legitimate capital expenditure and when they should be met out of earnings, is naturally always debatable. Conservative management tends strongly to decide the question in favor of the second alternative. When it is not so decided, there is always a danger at least of investing fresh capital in a form that will bring little if any returns. The statement is so obvious that no illustration is needed to enforce it. Its importance, however, should not be overlooked. In connection with the subject of distribution of income, the question as to the proper financing of betterments will be discussed at greater length.

Investing Capital in Side Lines

As has been remarked, the managers of a corporation that has proved successful are seldom willing to stop. They wish to go ahead and enlarge their profits. This statement applies notably to the business men of the United States. In England and other countries business customs favor building up a sound business and maintaining it rather than restlessly pushing into other fields. No doubt the American practice makes for progressiveness, yet it also involves a constantly recurring danger of disaster.

The number of companies which have taken on "side line" enterprises to their sorrow is far beyond what would usually be supposed. A conspicuous example is the American Locomotive Company which some years ago decided to engage in the business of manufacturing automobiles. The plant was poorly located and it is to be presumed that the officers had neither the time nor the special training which would have enabled them to handle this business with success. In 1913 internal dissension in the company brought to light the fact that over \$2,300,000 had been lost during that year in the automobile enterprise. Subsequently the directors decided to accept their loss, dispose of the plant and other assets, and close all their activities in this field.

In 1914 the American Water Works Guarantee Company became financially embarrassed. This company had been a highly successful promoter of public utility corporations and of holding companies operating in the public utility field. After having succeeded in this line, it attempted to carry out certain irrigation projects and invested in these projects more than \$10,000,000. In addition it eventually became necessary for the company to indorse more than \$23,000,000 of the obligations of its irrigation subsidiaries. The result was that this "side line" became the most important activity of the company and was the direct cause of its embarrassment.

On the other hand, it is sometimes true that a "side line" may prove to be the only really profitable feature of a business. For example, the London Underground Electric Railways Company shows investments of a nominal value of £17,000,000, of which £15,500,000 is in the various underground railway companies, and £1,500,000 is in the London General Omnibus Company. The profits from the underground railways were a trifle over 1%, or about £160,800; the profits from the omnibus service were nearly 23%, or approximately £377,000.

Some of the great meat-packing concerns such as Armour, Swift, and Morris, started a great many years ago to operate refrigerator cars primarily for transporting their own products. As a "side line" they began to run these cars for the benefit of producers of fruit and vegetables, with the result, as is well known, that operating car lines became, in time, one of the most profitable features of their business.

In the same way the United Fruit Company was originally designed merely to market tropical fruits, especially bananas. In the course of time, however, the company has taken over one "side line" after another until at present it conducts banana plantations, sugar plantations, railroads, tramways, steamships, and refrigerator car lines. It is understood that each of these developments has proved a profit-maker and that the company's revenue from its transportation interests is almost as great as from its original field of operation.

The United Cigar Stores Company is said to have developed successful "side lines," but has followed the policy of selling these lines after they were developed to separately organized and managed corporations. The profit-sharing coupons of the company have, for example, been taken over by the United Profit Sharing Corporation and the sale of chewing gum has been taken over by the Sterling Gum Company.

Perhaps the most definite conclusion that can be reached here is that the creation of "side lines" is a dangerous business policy. It involves a diversion of capital, of thought, and of creative energy that would otherwise go into building up the company's own business. This is especially the case when a "side line" is taken on that has no vital or necessary connection with the original and proper business of the company. In that case, it calls for an especially heavy drain on the talent and resources of the company. The "side line" that develops naturally and almost unavoidably is of a different type. It may be considered as rather in the nature of an extension than a "side line."

Even when a "side line" is successful, the question still remains whether the application of an equal amount of capital and of managerial ability to the company's own product would not have brought still greater success. Certain it is that those companies which have achieved the greatest records of growth are those which, like the Ford Motor Company, the National Cash Register Company, the Curtis Publishing Company, and thousands of others, have devoted themselves exclusively to turning out one or two cognate products and have never allowed money or energy to be diverted from this main purpose.

Investing Capital in Securities

Under this head we have to consider not the questions that arise in connection with the establishment or purchase of partly subsidiary enterprises, but those that arise in connection with using the surplus funds of a corporation partly for investment in the securities of non-related corporations. We shall see in a succeeding chapter, in discussing methods of utilizing surplus funds, that some corporations make it a practice to place a portion of these funds in salable securities. However, this is seldom carried to the extent of tying up in these investments a large proportion of the company's available

capital. The policy to be considered here is that which involves transforming a company from an active transportation, public utility, industrial, or trading enterprise into a company that has for one of its main functions investment of capital in securities.

It is seldom that this transformation is effected through the desire or even with the consent of the great body of stockholders. It is much more commonly the case that the active officers or directors of the company have private motives of their own for desiring to make use of the company's credit and other resources. The results achieved may conceivably in the long run be beneficial to the stockholders, but they do not affect the underlying motive.

This appears to have been the situation with the Union Pacific Railroad Company at the time when it was under the domination of the late Mr. E. H. Harriman. Mr. Harriman's first efforts were directed toward making the Union Pacific an efficient and profitable railroad property. Having succeeded—or being well on the way toward success—in these efforts, his personal ambitions led him to invest the surplus profits of the Union Pacific more and more heavily in other railroad companies and to utilize the credit of the Union Pacific in raising great sums of money for the purpose of consolidating and extending these investments in other railroad properties. Thus, in the course of time the Union Pacific became half a railroad company and half an investment company. The decision of the Supreme Court of the United States in 1912, which compelled the Union Pacific to part with its holdings of the securities of certain other railroad companies, has in part remedied but has not completely changed this state of affairs.

The Adams Express Company has total assets of approximately \$70,000,000, out of which "securities and investments" comprise \$57,000,000. Its total earnings from investments

average 25 to 50% higher than its earnings from its own operations.

On October 23, 1914, announcement was made of the appointment of a receiver for the Toledo, St. Louis and Western (Clover Leaf) Railroad. Undoubtedly the prime reason for the failure was the investment of \$11,500,000, in 1907, in common and preferred shares of the Chicago and Alton Railroad Company. The dividend record on the acquired shares was as follows:

	Common	Preferred
1907	...	4%
1908	1%	4%
1909	4%	4%
1910	2%	4%
1911	...	2%
1912	...	...
No dividends since.		

When in 1906 Mr. E. H. Harriman was questioned by the Interstate Commerce Commission as to the status of the Alton Railroad, he replied quickly, "You will have to ask the Rock Island people; they are carrying the bag." The following year the Rock Island succeeded in unloading on the Clover Leaf. The loss to the Rock Island on this transaction, however, was heavy. It has been estimated at approximately \$5,000,000.

Another painful experience in making investments fell to the lot of the Rock Island Company. In 1902 Rock Island purchased Frisco common stock to the par value of \$28,930,300, giving in payment \$60 per share in 5% bonds and \$60 in common stock. Seven years later the Rock Island management sold the Frisco stock back to the original vendors at \$37.50 per share, or \$10,848,250. But before the stock could be transferred, it was necessary to pay the collateral trust

bonds, which were callable at 102½ and interest. To pay off these bonds required \$18,160,037 cash, which was \$7,311,175 more than was received from the sale of the Frisco stock. To raise this additional cash, \$7,500,000 of debenture bonds were issued. During the seven years the Rock Island owned the Frisco stock, it paid out in interest on the Frisco collateral trust bonds \$6,077,000, and did not receive a cent of dividends on its holdings of Frisco stock. The actual money loss to the Rock Island Company was, therefore, \$13,388,175. In addition, the Rock Island Company has outstanding \$17,364,180 of its own stock, which was issued in part consideration for the Frisco stock.

In studying the records of large corporations which have made investments on a great scale, one is more and more impressed with the idea that the men at the head of these corporations seem at times to lose their judgment in the handling of the enormous credit power that is under their control. They are apt to imagine that ordinary rules of sound judgment and careful figuring do not apply to them. They are in somewhat the same state of mind as the large clothing manufacturer to whom it was demonstrated that a big percentage of his product was being sold below cost, "Oh, that will come out all right," airily replied the manufacturer. "You overlook the great scale upon which our operations are carried on."

Another factor which makes for recklessness is the astonishing ease with which large corporations can issue stocks and bonds in exchange for property. It is apparently so simple and so tempting a thing to do—to have a few more pieces of paper engraved and given in exchange for railroads, factories, and control over the labor of thousands of men—that it requires a level head to keep clearly in mind that these new pieces of paper are so many additional obligations which sooner or later must be met.

Relative Amounts of Fixed and Working Capital

This chapter has been devoted, in part, to emphasizing the necessity for providing adequate working capital. The result may be to restrict the investment in fixed forms and thus to limit the output and profit-making possibilities of the business. Such a policy would insure a degree of safety, even in the presence of emergencies, which comes only from the possession of an adequate working capital. The popular impression seems to be that it is absolutely essential for a corporation to possess fixed assets which will enable it to turn out its product, whatever that product may be, and that whatever sum is left over will necessarily have to serve as working capital. There is probably no more dangerous fallacy in the whole range of business thought and action. The fact of the case is that, for most corporations adequate working capital is essential, while adequate fixed capital becomes desirable and necessary only after the success of the business has been fully demonstrated. This last statement is not intended to apply, of course, to those lines of business, particularly transportation and public utilities, in which working capital is not a requisite.

To make the case concrete, let us suppose that a water power company is working out a fully completed project for installing a power plant and for serving manufacturing and public utility enterprises throughout a given district. We will assume that contracts for delivery of all the power that can be produced have already been assured and that the payments on these contracts are to be made monthly in advance. Under these conditions, we have an instance of a corporation which must have an amount of fixed capital that can be closely estimated in advance, and which must be sufficient to enable it to complete its whole installation. It needs no working capital, for the monthly cash receipts will be more than sufficient to meet its monthly outgo.

But let us take, also, the very common case of a corporation which is designed to produce and sell a patented device. Frequently the first step is to raise whatever fixed capital is required in order to build a plant and install equipment. Even though the company may have sufficient working capital, it is more than likely to find out a little later that the device itself, or the methods by which it is made, are not in their final form and much of the fixed capital will be wasted.

A far more sensible procedure in most cases would be to have the device manufactured during the first year or two by some company which will take over the manufacturing contract, and to devote all the available capital to building up a selling plan and selling organization, to financing sales, to establishing the credit of the new corporation, and to installing whatever mechanical or business improvements are called for. That is to say, all the resources at the beginning should be kept in the form of working capital. After the selling problem has been solved and the final form of the product has been determined, it will be time enough to proceed with the erection of a plant. If this procedure were more generally followed, there would be fewer setbacks and failures in business.

A closely related fallacy is the common idea that "more capital" is needed in order to make a business move ahead successfully, whereas the real need, ordinarily, is for a better use of the capital already available, and for a demonstration on a small scale that the enterprise can be made a profit-maker. After that demonstration has been given, it is usually comparatively easy to raise fresh capital.

CHAPTER XVII

CALCULATING REQUIREMENTS FOR WORKING CAPITAL

Factors to Be Considered

In the preceding chapter the necessity for adequate working capital in most lines of business has been emphasized. The question as to what is to be considered "adequate" in any given case, however, has been left open. It would be too much to expect that this chapter should present an exact arithmetical answer, or even a formula for arriving at the answer. There are too many variable factors to be considered. We can, however, list and discuss the most important of these factors, and perhaps in this way throw a little additional light on one of the most difficult and most vital problems in the field of business financing.

Following are the factors which require chief consideration when the amount of working capital required by a given enterprise is to be calculated:

1. Length of period of manufacture.
2. Turnover.
3. Terms of purchase.
4. Terms of sale.
5. Facilities for converting current assets into cash.
6. Seasonal variations in the business.

It may be well to repeat at this point the definition of working capital as "excess of current assets over current liabilities." In transportation and other enterprises which do not carry any excess of assets over liabilities, there is no working capital; in manufacturing enterprises it is generally

considered that the proportion of assets to liabilities should not be lower than 100 to 75, or 100 to 80. Sometimes the same ratio is expressed in the reverse order, and it is stated in mortgage indentures that current assets shall never be less than 133 $\frac{1}{3}$ % or 125% of current liabilities. These ratios are not in themselves fixed and final standards. It would be far better to determine the amount of working capital in some more definite manner; if the amount is sufficient, we may be certain that the ratio of current liabilities to current assets will always be well within the limits of safety.

Length of Period of Manufacture

A company turning out a product which requires a long period of manufacture will be compelled to purchase raw materials, pay for labor and other expenses incident to manufacture, and wait for a long period before the finished product is ready to sell. Large amounts of capital will necessarily be tied up in the process of manufacture itself. As an extreme instance, take shipbuilding. To build and equip a large vessel may require three or four years. The outlay may amount to several millions of dollars. In case the product is not paid for until delivery, and in case several vessels are under construction at the same time, it is clear that the amount of capital invested in raw materials, partly finished products, and other forms of working assets will soon become enormous. Like remarks apply to the erection of large buildings or other important pieces of construction which may require several years' time and the investment of millions of dollars before the product is completed.

In these extreme instances, the problem is solved by throwing a large part of the burden of providing the expenses of construction upon the purchaser. Contracts for construction of all kinds almost invariably provide for inspection and acceptance of the work that has been completed up to given stages

or at given intervals, and for payment on account by the purchaser of a proportionate share of the contract price. This arrangement is customary even with comparatively small pieces of construction, such as the installation of bank vaults, the erection of small dwellings, and the like.

Even with this proviso, it is usually the case that construction and contracting firms are called upon to lay out large sums and to wait for a considerable period before they are reimbursed, and it is quite necessary, therefore, that their working capital should be correspondingly ample. There is scarcely any line of business in which insolvencies are more frequent than in contracting. The explanation is nearly always the same; the working capital of the contracting firm is not sufficient to "swing" its undertakings. This is a difficulty which is peculiarly apt to confront all enterprising, progressive, and otherwise successful contractors.

In the extreme instances that have just been cited, the necessity of securing either an exceptionally large working capital or a series of payments on account in advance of delivery of the finished product, is universally recognized. But there are many less extreme cases in which the importance of this factor seems easily to be overlooked. In many processes of manufacture, time is one of the important elements. This is true particularly in handling "green" products such as lumber and hides; in making wines and distilling liquors of good quality; in developing suburban real estate; and so on indefinitely. The moment an effort is made to rush the process of turning out a finished product in any of these lines, the result is either a great increase in expense or an impairment in quality. On the other hand, it must not be forgotten that in slow processes provision for relatively large sums of working capital must be made. And in most cases it is not practicable to secure payment from the purchaser in advance of delivery of the finished product.

Moreover, there is a danger connected with long-process manufacturing, not on contract but for the general market, that fluctuations in prices may diminish or wipe out expected profits. To take care of such fluctuations and to carry the company through periods of distress which may result, it is essential both that the average profits should be high and that the supply of working capital should be ample.

This was one of the main sources of trouble for the United States Leather Company when the combination was first formed; between the date of purchase of green "packer" hides in this country and the actual sale of the finished leather, from six to twelve months usually elapsed. Between the purchase of Argentine hides and the sale to a foreign consumer, this period may be extended to a year and a half or more. At a time of falling prices, the price of hides lags behind that of leather. As a result, in the middle 90's, the United States Leather Company repeatedly sold leather for less than its cost of production.*

Still another handicap to a business in which the period of manufacture is lengthy, is the impossibility of making quick adjustments to market conditions. By way of contrast, consider the case of a company at the other end of the scale—a bread-baking company, which manufactures overnight the product that it sells the next morning. If there were to take place a sudden shifting of demand from one kind of bread to another, or even away from bread altogether toward some other kind of food, the bakers obviously could adjust themselves to the change in short order. The leather manufacturer has no such advantage. He is continually tied up with enormous quantities of hides and of leather in the various stages of manufacture. It is at least expensive, and in many cases impossible, for him to shift from one kind of product to another. He may suffer—and in fact many leather manufac-

*Dewing's "Corporate Promotions and Reorganizations," p. 25.

turers have suffered—severe losses due simply to changes in taste on the part of the consuming public.

It is clear that the length of period of manufacture is an important factor in determining how much working capital a corporation will need. A breadmaker does not risk as much in proportion to the volume of his business as does the leather manufacturer; for he has scarcely paid for his flour and labor before the receipts from his sales flow back to him.

One important improvement in automobile manufacturing which within recent years has put it on a safer and more stable basis, is the reduction in the length of time required for turning out finished cars.

Turnover

A closely related factor is the rapidity of turnover of working capital. Although the word “turnover” has come to be highly popular, there is a remarkable absence of clear-cut, authoritative definition. Observation of customary usage, however, makes it plain that its meaning in the minds of merchants and manufacturers is always the same. “Turnover” may be defined as the ratio of annual gross sales to average working assets. It is the figure, in other words, which shows how many times the amount invested in working assets has been traded in or “turned over” during a year. Note that the relation is between gross sales and *working assets*, not between gross sales and *working capital*. There would be some advantage in basing figures on the second relation, but it is not customary to do so and it seems advisable to fall into line with customary business practice.

We hear a great deal about turnover in trading operations, particularly in retail merchandising, and comparatively little about it in manufacturing operations. It is, to be sure, relatively of greater importance to the merchandiser than to the manufacturer, but it is by no means unimportant to the latter.

As has previously been remarked, almost all the assets of a trading concern are working assets; the only capital invested in fixed assets is that which is given up to office furniture, store equipment, and the like. Both the wholesaler and retailer customarily buy on fairly liberal terms of credit and endeavor to sell the merchandise and make collections before their bills for the merchandise fall due. If they could always be sure of accomplishing this result, there would be no necessity for their possessing working capital; but, as we shall see in the next section, there is a strong tendency in this country toward shortening the period during which merchandise bills run and there is also an ever-present uncertainty as to the retailer's ability to dispose of his products within any fixed period; consequently, for both these reasons, he is called upon to provide a certain amount of working capital and often a very large amount. The manufacturer's proportion of working capital to fixed capital is much smaller than the trader's proportion. Nevertheless, up to the extent of his investment in working capital, he is interested as well as the trader in turnover.

It is clear that the greater the turnover, the larger the volume of business that can be conducted with a given working capital. If a retail store, for instance, is handling a product for which there is a great demand and which can be sold almost as rapidly as it is stocked, the gross sales will be large and the investment in stock will be small. If sales, on the other hand, are irregular and slow, the amount of working capital invested in stock will necessarily be heavy.

This is the first element in determining the rapidity of turnover. A daily newspaper stand will necessarily have a very rapid turnover, for the capital invested, plus the dealer's profit, will be realized in cash, at least once a day, and in the larger cities three or more times a day. The turnover for the newsdealer, under the above definition, is 500 to 700 times per year. As soon as the newsdealer adds a stock of

magazines and books, which sell more slowly, his turnover decreases. At the other end of the scale is a great jewelry store, such as Tiffany's, in which it is necessary to provide an immense stock of valuable goods from which the customer may choose, while at the same time the sales are comparatively irregular and infrequent. Evidently the turnover in a business of this kind must be small.

In addition to the timeliness of the merchandise that is carried for sale and the degree of standardization of the merchandise, which determines how much stock must be carried in order to give a satisfactory range of choice to the customer, another element that determines rapidity of turnover is the sales policy of the merchandising firm. If the sales efforts are strongly directed toward disposing of a given stock of goods quickly—if necessary, making a sacrifice in price or incurring an extraordinary selling expense in order to achieve this result—the rate of turnover will clearly be higher than in case there is no definite, clearly thought-out sales policy. Right here is the point at which the financing of great numbers of retail stores breaks down. If a proprietor fails to recognize the great importance of achieving volume of sales and rapidity of turnover, even though an incidental sacrifice of profits here and there may be involved, the result is that his shelves gradually become loaded with unsalable goods; his receipts are not sufficient to meet promptly all his obligations for merchandise; his bills accumulate and his credit declines; and eventually he finds himself—usually to his own surprise—in a receivership or in bankruptcy.

Precisely the same elements determine the rapidity of turnover in manufacturing concerns. The timeliness or immediate salability of the manufactured product determines whether he keeps his stock of raw materials, half-finished products, and finished products moving or whether it piles up on his hands. Second, by standardization of his product,

accompanied by advertising which impresses the consumer with the superiority of the standardized product, the manufacturer may cut down the number of his styles or varieties that he turns out. The automobile manufacturers have learned that one or two styles of chassis, each with two or three styles of body, is an ample line for any one manufacturer. Those that have been most successful do not offer even this much of a choice. Thousands of manufacturers are still turning out a large variety of products to meet the tastes—often the whims—of customers, when it would be possible for them to standardize both the demand and their own output and thus increase to a wonderful extent the turnover of their working assets. The third element—definite sales policy which endeavors to “clean up” accumulating stock—is almost as essential to the successful manufacturer as to the merchandiser.

In determining the rapidity of turnover the manufacturer is more or less circumscribed by one element that does not affect the merchandiser, namely, the length of period of manufacture. The merchandiser buys only finished products, and in order to attain a satisfactory turnover has only to stimulate the sales. The manufacturer, however, if his period of production is lengthy, will necessarily have a small ratio of turnover no matter what sales efforts he may put forth.

It would be impossible to state definite figures for turnover in the various lines of business. In general retail store merchandising, the turnover has been known to go as high as 8 or 10, but this is exceptional. Ordinarily 2, 3 or 4—depending on the location of the store, the class of goods carried, and so on—would be regarded as a satisfactory turnover.

Investigations carried on by the Bureau of Business Research of Harvard University show that the rate of turnover in retail shoe stores ranges from 1 up to 3.6. The turnover in a large number of these stores was found to be 1.8, and

the Bureau considers a turnover of 2.5 as a realizable standard in the average retail shoe store.*

Terms of Purchase

If an enterprise is paying cash for everything it buys and is selling on credit, it will obviously need a working capital sufficient to purchase outright its entire stock of goods, including everything that has been sold but not yet paid for. On the other hand, if the enterprise is able to buy on long credit and sell for cash, it can provide its whole stock with no immediate outlay and will pay its bills as they mature out of receipts from its own sales. Ordinarily, neither one of these extreme arrangements prevails. Goods are both bought and sold, at least in part, on a credit basis.

The tendency within the United States, however, during the last two or three decades has been strongly toward reducing the length of credit available to purchasers of raw materials and of goods for resale. This reduction in the period of credit has been brought about, not by an apparent exercise of pressure, but by granting special "concessions" to those who were able to pay cash or to pay within 10 to 30 days. Gradually, as these concessions have come to be more and more accepted, the competition among retailers has made it more and more necessary that they should be accepted. Moreover, the increasing tendency in this direction has now made it the custom in many lines of business to purchase for cash or on short time, and has therefore placed the sellers of merchandise in a position to insist upon prompt payment.

In retail stores, for example, forty years ago it was not uncommon, nor was it considered improper, for a retail merchant to purchase a line of goods on six months' time. Sometimes he was compelled to ask for further extensions. A little later some of the wholesalers who felt the need of more

*Bulletin of the Bureau of Business Research, Harvard University, No. 1, May, 1913, p. 14.

available cash in their own business began to offer liberal discounts for payment within 30 to 60 or 90 days; and well-to-do retail merchants gladly took advantage of these discounts. Other merchants, as will be more fully explained later on in this chapter, saw the advantage to themselves of borrowing from their local banks at fairly low rates of interest, thus securing funds with which they could take advantage of the discounts offered to them. After this custom became firmly established, the wholesalers began to expect prompt payment and, although the terms were still nominally three months to six months with a discount for anticipating payment, the wholesaler based his calculations on the cash price and the so-called "discount" came to be more and more in the nature of a penalty imposed upon those who failed to pay their bills within 10 to 30 days. So well understood is this custom at the present time, that a merchant who fails to take advantage of the cash discount offered to him is soon looked upon with suspicion.

Any so-called discount which is far in excess of customary rates of interest is to be regarded as a penalty for non-payment of bills rather than as an incentive to prompt payment. A striking example is the custom among periodicals of rendering bills for advertising space nominally payable within 30 days, but with a discount of 2 to 5% for payment within 10 days. Inasmuch as these bills are customarily rendered before the issue containing the advertisement is actually ready for distribution, the publisher usually receives his payment in advance of any service that he has rendered to the advertiser. Doubtless the custom arose out of the danger that advertising space may be lightly ordered by concerns which have little real use for it or are unable to pay for it; hence the publisher feels justified in practically demanding—through the medium of abnormal discount rates—that payment be made in advance.

In the "capital-poor" countries in which industry and trade are constantly tending to expand more rapidly than adequate capital for developing them can be obtained, the custom of granting long terms to purchasers for manufacture or re-sale, which formerly prevailed in this country, continues to exist. In Argentina, for example, it has during recent years been customary for importers and wholesalers of merchandise to sell to the general retailers in the farming districts on 90 to 180 days' time and in addition make liberal provisions for renewal of the retailer's obligations. In turn, the retailer customarily sold goods to the farmers and others in his district on similar long terms. Frequently, the retailer was able to go a step further and actually make advances to his customers in order to enable them to carry on their farming operations and harvest their crops. Each year as the crops were brought to the market and sold, the farmers were able to repay the merchants for all the advances and the goods they had received during the preceding several months, and the retail merchant was then in position to settle his obligations to the wholesaler, who in turn was able to clear up his obligations. Under this system the importer and wholesaler were "carried" in part by the manufacturers—chiefly in foreign countries—from whom they purchased; the retailers were "carried" by the wholesale dealers; and the farmers and other consumers of goods were "carried" by the retail merchants. In years when the crops were good, the harvest months were a period of rejoicing and realization of good profits on the part of every one. When the crops were bad, the entire structure of mercantile credit was shaken and a large proportion of the weaker concerns inevitably went to the wall.

In European countries the general custom prevails of accompanying invoices for shipments of goods with drafts drawn on the purchaser usually for 30 or 60 days. After

receiving the goods and satisfying himself that they are in good condition, the purchaser "accepts" the draft which then becomes an obligation on his part of the same general character as if he had given a promissory note. The "accepted" draft may be discounted by the house which sold the goods, at its own bank or may even be sold in the open market. At any rate, the seller of the goods quickly and easily collects payment, while the purchaser of the goods has an opportunity to adjust his affairs, knowing that he will be called upon to meet his accepted draft on a given day. This system is claimed by many bankers to have noteworthy advantages over the custom which prevails in the United States of persuading the retailer through the use of penalty discounts to pay cash for his purchases.

The system prevailing in this country is made possible only by the existence of great numbers of local banks. The local merchant is in position to borrow from these banks and thus to take upon his own shoulders the whole burden of financing his purchases of goods, whereas in other countries the seller of the goods, either through his own resources or through his banking connections, attends to the financing of the transaction. The same custom has not as yet come to prevail when the manufacturers are the purchasers of goods. Ordinarily they buy on 30 to 90 days' time, or in case of special and exclusive contracts often on longer time. It is usual, however, when accounts run for longer than two to four months, for the purchaser to give in payment his promissory note which the seller may then discount at his own bank. The tendency is strong even here to reduce the period of credit and through the offer of discounts to bring pressure to bear for the prompt cash payment of accounts. Unless some contrary tendency should make itself felt, we may reasonably expect, as time goes on, to see the burden of financing dealings in raw materials, as well

as in finished products, assumed to a greater and greater extent by the purchaser.

The effect of this tendency on working capital is self-evident. When the purchases of a firm are made on long-term credits and money is collected from sales before the corresponding obligations fall due, working capital is required only to take care of emergencies. But when the purchaser undertakes to pay cash, he must either possess so much working capital that he can make payment out of his own resources, or at least he must possess enough to provide a margin of safety which will enable him to borrow from banks without question and on favorable terms. The shorter the period of credit that is customarily used by a firm in making purchases, the larger must be the working capital of the firm.

Terms of Sale

Looking now at dealings in raw materials and merchandise from the seller's point of view, let us consider the effect upon working capital of the customary or average terms of sale. We shall give particular attention to two classes of transactions that were not treated in the preceding section, viz., sales to purchasers in foreign countries and sales by the retailer to the consumer.

So far as dealings between producers and those who purchase for manufacture or resale are concerned, these dealings have been discussed at sufficient length in the preceding pages. It is enough here to state the corollary of the conclusion therein reached, viz., the longer the period of credit which it is necessary to extend in effecting sales, the larger must be the amount of working capital.

There are some special considerations, however, that modify this conclusion in its application to financing sales in foreign countries. These special considerations arise out of the

fact that the methods of financing these foreign sales differ somewhat from the method of financing a domestic sale. First of all, the domestic sale is usually on open account; hence, the seller does not come into possession of a piece of commercial paper which he can readily discount. When the terms of credit are longer than two to four months, as has been noted above, the principal may give his promissory note, but it is not the customary type of transaction in this country. In foreign trade, however, the European custom is followed of accompanying the shipments of goods with a draft drawn upon the purchaser. In the South American trade this draft is usually due for payment 90 days after the goods have arrived at their destination; on arrival of the goods it is expected that the purchaser will promptly inspect them and, if they are in accordance with his order, will "accept" the draft which in the meantime will have been forwarded to one of his local banks. Inasmuch as it requires at least a month, or usually more on an average, to secure delivery of shipments from this country to South American countries, and another month is required before funds paid at a South American city can be transferred by mail to a city within the United States, there is an interval of at least five months to be bridged over between the date of shipment and the date of receiving payment—one month for the shipment and draft to reach destination, three months until maturity of the draft, and one month thereafter until payment reaches the shipper in the United States. It should be borne in mind, also, that five months is almost the minimum period. In case it is desirable or necessary to renew the draft, or in case communication requires more than one month, the period before final payment is received may drag out to six or nine months or even more.

If a manufacturer is to build up export trade as an important feature of his business, it is evident that he must either

provide a great addition to his working capital or he must have assistance of some kind in financing this export trade.

In the countries which are the chief commercial competitors of the United States—England and Germany—systems of financing foreign sales are worked out in great detail; and this constitutes one of the most important advantages which these countries enjoy in competing with American manufacturers in such markets as those of the Far East and South America. A like system is now in process of formation in this country. It is to be hoped that it will be completely worked out in time to enable American manufacturing exporters to get a firm hold on the trade in competitive markets during the present favorable conditions.

Basically there are five possible methods under which the manufacturer who is making export shipments may quickly realize the cash value of his shipments:

1. He may turn over the financing (with or without the selling) to a firm of commission merchants who agree to pay the manufacturer in cash and to charge a sufficiently higher price to the customer to compensate them for their special knowledge, advances of money, and risk. In some lines, and with the proviso that the right kind of contract is made with commission houses, this may prove to be a satisfactory method.

2. The exporter may carry through his own sales, draw a draft in accordance with the usual custom to accompany the shipment, turn the draft—or bill of exchange as it is more commonly called—over to his local bank to send forward for collection, and on the strength of this increased business secure from his bank an enlarged line of credit. This is very much the same plan that would be followed if the manufacturer were to increase his domestic business. It is usually highly unsatisfactory as a means of financing export shipments, however, because the banker is seldom willing to grant credit for a sufficient length of time, or to a large enough amount, to give the

manufacturer all the assistance that he needs. In other words, under this plan it is necessary for the manufacturer largely to increase his working capital in order to handle export trade and this places him at a disadvantage as compared with his foreign competitors.

3. The manufacturer may forward his bills of exchange for collection through his bank, and arrange with the bank to give him an advance up to a fixed percentage of each draft. This percentage may be as low as 50% or as high as 90%, or even 95%. This is certainly a better arrangement both for the manufacturer and for the banker, inasmuch as it gives the manufacturer a larger amount of available credit which varies in direct proportion to his foreign business, and gives the banker a direct collateral of good quality to secure his advances. Until recently it has been the method most widely used within the United States, and is also much used in England and Germany. The chief objection to it is that it does not go far enough, inasmuch as the percentage of safety which the American banker requires is much higher than the percentage customarily required in competitive countries.

4. The exporter may actually "discount" or "sell" his bill of exchange, to a banker who is doing business through a branch or through a closely allied correspondent in the district to which the shipment is going. The bill is usually bought "with recourse," which means that the banker reserves the right to demand payment of the draft from the exporter in case the importer fails to meet it promptly. It is usually discounted at 6%, more or less, with an additional commission charge of perhaps $\frac{1}{2}\%$. This is, on the whole, a satisfactory method of financing so far as the manufacturer is concerned. He gets his money, minus a reasonable discount and commission charge, at once, and thus is not stripped of working capital. To be sure, a contingent liability remains, but, unless his sales policy is defective in the extreme, there

will be very few cases in which his bills go to protest. The chief objection is that the banks of the United States are not, as a rule, sufficiently well represented abroad to carry on this business, so that it is conducted chiefly by agencies of foreign banks in New York City.

5. The exporter may turn over his bill to his bank to forward for collection, and the bank in turn may permit the exporter to draw another draft on the bank, which the bank "accepts." The exporter may then take this "accepted" draft into the open market and sell it for whatever it will bring. Inasmuch as an accepted draft is practically equivalent to a promissory note, those drafts which have been accepted by strong banks, are salable at a very low discount rate. The bank charges a small commission, equivalent to about 1 to 2% per annum, for stamping its acceptance on a draft. Usually the draft drawn on a bank is for 80 to 95% of the amount of the exporter's draft on his customer. This method has been possible in the United States only since the Federal Reserve Act went into effect in November, 1914. It is simple and practical and gives to most exporters the financial assistance that they require. Usually the manufacturer is able, through this method, to get returned at once at least the full amount of the cost to him of manufacturing and selling the goods he is shipping, and is compelled to wait only for his profit on the transaction. That being the case, he may carry on as much export trade as can be financed in this way without direct increase in his working capital.

As was remarked in the preceding section, the English custom is to accompany almost all shipments, domestic as well as foreign, with drafts, which are accepted by the purchasing house and thereupon become a good quality of marketable paper which banks are quite ready to discount. This system enables the manufacturer to borrow large amounts from his banks with safety, and to count upon this borrowing as a

permanent source of funds not subject to the more or less arbitrary conditions that bankers find it necessary to impose under the American system. The English manufacturers and trades, therefore, are in position to carry on their business with a much smaller amount of working capital than is required by a business of corresponding volume in this country. Take an example at random: The well-known English firm of Bolckow and Vaughan, manufacturers of iron and steel, carried on a recent balance sheet current assets as follows:

Sundry Debtors (Accounts Receivable)	£224,000
Stocks (Inventories)	750,000
Cash	39,000
Total	£1,013,000

The Sundry Creditors (Accounts Payable) were listed at £500,000.

Note the remarkably small amount of cash in proportion to the current assets and liabilities. The fact that so large and prosperous a firm should carry so little cash can be accounted for only as a result of the English practice with regard to financing sales which has just been alluded to. Under this practice it is easy for the manufacturer or trader to realize on his sales and secure whatever cash he needs on short notice.

For this reason it is important that better facilities should be developed in the United States for financing sales abroad and long-term sales within this country. If this were done, and probably it will be done, the amount of working capital required to handle a given volume of business would be much reduced. For the time being, however, and until these facilities are more fully and more efficiently supplied, we must in many cases figure that any increase in sales which is accompanied by a lengthening of the terms of payment will necessarily involve a disproportionate addition to working capital.

Financing Instalment Sales

Another highly important departure in American business practice which involves difficulties of financing and calls for some special consideration, is the growth in the custom of making retail sales of high-priced goods, payments for which are deferred and are made in instalments. This is a practice which already has a wide application and which gives promise of spreading. Originally, "selling on the instalment plan" was confined largely to high-priced sets of books and a few other articles of luxury. At the present time, however, it is the customary plan of sale in such widely separated lines as pianos, suburban real estate, agricultural machinery, courses of instruction, and sewing machines. It is being introduced more and more also in selling clothing, furniture, jewelry, motor cycles, automobiles, and many other articles.

There has been much opposition to this wide-spread use of the instalment plan, on the ground that it leads thousands of imprudent people into buying articles that they do not need and incurring debts which easily grow to be a serious burden. In so far as the instalment plan is used in selling articles of luxury that do not in any way add to the efficiency or the earning power of the buyer, this objection seems to be well founded. It is equally clear, however, that the objection does not apply when the article that is sold tends to increase earning power; for in that case the purchaser is simply making use of his credit, just as every business house should do, in order to enlarge his facilities for carrying on his activities as profitably as possible. He is following the same policy that the railroad follows when it purchases rolling stock on the instalment plan and gives its equipment notes in payment.

However, we need not here enter into any discussion of the social aspects of instalment selling. The only point that really concerns us is the financial problem that confronts the manufacturer or retailer who adopts the instalment plan. Fre-

quently it has been adopted without the slightest realization, apparently, that any financial problem accompanies it. As a result, hundreds—or more likely thousands—of instalment houses in various lines of business have been wound up in bankruptcy proceedings and the whole method, no matter how it may be applied, has come to be looked upon by bankers with much distrust. Here, again, some discrimination should be used.

The financial difficulty arises out of the simple fact that the whole cost of the product that is being sold, plus the cost of selling and of overhead administration, is paid out before the product is delivered to the customer, whereas payment is received only in small periodic amounts extending usually over several months. In disposing of real estate on the instalment plan, it is not uncommon for payments to be spread over five to ten years or even longer. In selling pianos the payments frequently spread over as long as three years; in selling furniture, agricultural machinery, and the like, the term of payment is customarily about one year.

A secondary financial difficulty arises out of the fact that a certain proportion of the sales will be made to people who cannot, or will not, live up to their contracts. The manufacturer or retailer may then proceed to take back his goods, but they will usually be in a damaged condition. In any case the expense of making and handling the sale and of attempting to collect the instalment payment will have been incurred and cannot be recovered. The expenses and losses of collection together constitute an item that must be carefully calculated and taken into consideration in every instalment business.

The simplest and one of the most common forms of instalment contract is an agreement on the part of the purchaser to pay the fixed price of the article he acquires at the periods and in the amounts agreed upon, in return for which the purchaser obtains full possession of and title to the goods.

The seller under this agreement has practically nothing except an "open account" against the purchaser. He depends largely upon the purchaser's good faith and on the average honesty of the people he is dealing with, which is usually high. It is this last element—the average honesty of his customers—which constitutes the seller's chief protection and chief asset. He may, of course, be able to enforce collection by legal process, and will probably make it his policy to do so whenever a purchaser gives evidence of acting in bad faith; but if he were compelled to make any large proportion of his collections by legal process, he would be out of business in a short time. In spite of its apparent looseness and the heavy risk which the owner of merchandise appears to take whenever he parts with it on such terms, instalment houses that are selling a really meritorious product by proper methods to a good class of people find that they can count with perfect safety on only a small proportion of expenses and losses in making collections.

Where the amount involved in each sale, however, is large, or where it is desirable to reserve as full protection as possible for the selling house in order to satisfy bankers' ideas, two variations—both designed for the protection of the seller—may be introduced. One of these variations consists of retaining title to the property in the hands of the seller until after the agreed price has been paid in full. This is the arrangement when equipment is sold to railroad companies. It is customary in selling pianos, furniture, real estate, and many other high-priced articles. The legal interpretation of what is commonly known as a "lease contract," under which the instalment payments are technically regarded as rental until after the final instalment has been paid, when title passes to the purchaser, varies from one jurisdiction to another. In some states it has been held to be practically the equivalent of a sale and the title is regarded as having passed to the

purchaser at the beginning of the transaction. In most jurisdictions, however, the lease form of contract is upheld. Much indignation has been aroused—some of it doubtless justified—at the attitude of some dealers who have sold furniture under lease contracts and at the first sign of default have taken back the furniture and at the same time retained all the payments that have been made by the purchaser. There often seems to be injustice in such procedure; and yet the seller may usually claim with truth that he is actually the chief loser in every such case and it is necessary for him to take drastic action in order to protect himself against fraud.

The second variation is that of requiring the purchaser to give a series of notes covering his instalment payments. This puts the transaction into a much more definite, irrevocable form, and also assists the seller, as we shall see presently, in making his financial arrangements. Where the amount is large—say several hundred dollars or more—it is almost always wise to require the purchaser to give a series of notes. Where the amount of the transaction is small, the difficulty of getting the notes and the annoyance which the customer feels in giving a note for a small amount are drawbacks which are not compensated for by any general increase in the seller's safety. It does not pay to sue for payment of notes of small denomination. Except for a shadowy moral influence, therefore, the instalment seller is not materially better off for having the small notes in his possession than when he simply has on his books an open account against the purchaser.

Working Capital Requirements for Instalment Selling

Coming back now to the financial problem of carrying on an instalment business, let us take the hypothetical case of a product which sells at a retail price of \$100. We will say that the cost to the manufacturer or retailer is \$60, the selling expense is \$20, and the overhead charges, including collection

expense and loss, are \$10, leaving net profits of \$10. We will assume that the firm which sells this product disposes of 50 of the articles during the first month of operations; 100 the second month; 150 the third month; 200 the fourth month; and thereafter regularly sells 200 each month. We will assume, further, that instalment payments are made at the rate of \$10 per month. In order to simplify the problem, we will make the arbitrary assumption that the whole \$90 outgo, including collection expense and loss, is incurred at the time each sale is made. Under these assumed conditions, how much working capital will be required to "swing" the stated volume of business? During the first month the outgo would be 50 times \$90, or \$4,500 and the cash receipts would be 50 times \$10, or \$500, leaving a cash deficiency of \$4,000. During the second month the outgo would be 100 times \$90, or \$9,000, while the receipts would be \$500 covering sales made during the first month, plus \$1,000 for sales during the second month, making a total of \$1,500; leaving a cash deficiency of \$7,500. Putting these and succeeding calculations into tabular form, they would be as follows:

		Outgo	Receipts	Cash Deficiency for Month	Accumulating Deficiency
First	month	\$4,500	\$500	\$4,000	\$4,000
Second	"	9,000	1,500	7,500	11,500
Third	"	13,500	3,000	10,500	22,000
Fourth	"	18,000	5,000	13,000	35,000
Fifth	"	18,000	7,000	11,000	46,000
Sixth	"	18,000	9,000	9,000	55,000
Seventh	"	18,000	11,000	7,000	62,000
Eighth	"	18,000	13,000	5,000	67,000
Ninth	"	18,000	15,000	3,000	70,000
Tenth	"	18,000	17,000	1,000	71,000
Eleventh	"	18,000	18,500	500*	70,500
Twelfth	"	18,000	19,500	1,500*	69,000

*Excess receipts.

It is clear from the above table that, in case the instalment seller intends to carry the whole burden of financing on his own shoulders, he must be prepared with a working capital amounting at a maximum to \$71,000. Unless his business afterwards increases more rapidly than his cash receipts, he will be able later to draw large profits in cash which are the accumulated results of sales that he has made during the preceding months.

The case above given is necessarily crude, for within the space limits that can be assigned to the subject in this volume it would be impossible to enter into all the intricacies of the calculations that would be required in any actual case. The figures presented, however, serve to emphasize two principles which must be borne in mind in connection with all instalment financing:

1. During a period of rapidly increasing business the cash receipts cannot keep pace with the volume of sales and the outgo. Such a period, therefore, necessarily involves a severe strain on the financial resources of the instalment house. It is for this reason that prosperity and large sales have so frequently been the direct causes of financial disaster to firms that sell goods on instalments.

2. Inasmuch as cash receipts pile up much more slowly than sales, the first stage in building up an instalment business is a stage of heavy investment and of patient waiting. No matter what profits may be figured on the volume of business that is being done at this stage, it is evident that the realization of those profits in cash will necessarily be deferred to a later period. This preliminary stage may last for several years. After the business becomes fairly stationary, however, cash receipts from preceding sales begin to accumulate with rapidity and presently the financial position of the house becomes very strong.

The question arising in connection with every instalment

business, therefore, is: what can be done to shift some of the financial burden of building up the business from its own shoulders to the shoulders of its bankers or of other financial agencies? Unless this problem can be satisfactorily solved, an instalment house must necessarily be limited in its growth by the capital that can be contributed by those directly interested in the company. The problem is made peculiarly difficult by the fact, to which allusion has previously been made, that bankers, as a rule, have not been favorably impressed by their dealings with instalment houses and are not inclined to look with much favor on propositions to aid in financing such enterprises. In fact it may be said that, so far as new enterprises which sell on the instalment plan are concerned, they cannot reasonably hope for financial assistance from banks until after their business has become well-established and has proved itself sound and profitable.

Established instalment enterprises, which have a growing business and therefore require additional financing, are ordinarily able to obtain the temporary advances of working capital that they need in one of three ways:

1. By securing a large line of credit from their banks simply on the strength of their general showing of profits and their accumulating assets, consisting of instalment accounts receivable.
2. By securing, as indicated above, notes from their purchasers. Those concerns which make their sales in units of considerable size are frequently able to discount these notes or to place them as collateral for bank loans and are thus able to finance their requirements. This is very largely done by firms which sell agricultural machinery. The chief financial strain upon them is largely in the nature of a seasonable strain and the financial help which

they require, is, therefore, of a more temporary nature than is the help required by instalment houses the business of which is not greatly affected by the seasons.

3. By making arrangements, not with a bank, but with a financing company, which will either purchase their instalment accounts or instalment notes receivable, or will make advances against these accounts or notes which are put up as collateral.

This last method brings us to the subject of converting assets into cash, which is treated in the next section.

Converting Working Assets into Cash

The distinction between "quick" assets and "working" assets has already been noted (Chapter XVI). We can go a step farther and make a like distinction between cash and other quick assets; under the latter classification are to be included accounts and notes receivable that mature within a few days and merchandise which is already sold or is readily salable for cash. The only asset that is acceptable in settling bills is cash, but other quick assets may be counted as almost equivalent to cash.

Those current assets which are convertible into cash only after a considerable lapse of time or after considerable effort, belong in a different category. It is dangerous to count on them as if they were cash, for numerous contingencies may interfere with their being converted into ready cash at the time that has been anticipated. Many a merchant has found himself suddenly face to face with bankruptcy because he counted merchandise on his shelves as if it were already sold and later found it to be unsalable; or because he looked upon accounts receivable on his books as if they were already collected and later found that some of his important customers were themselves embarrassed or were "slow pay." It is be-

cause these contingencies exist, that it is necessary in the prudent management of most business concerns to maintain current assets at an aggregate figure considerably exceeding current liabilities. In manufacturing concerns, as we have seen, the current assets are usually regarded as normal if they are 125 to 133% of current liabilities.

The more readily the current assets of a corporation are convertible into cash, the less need be the proportion of current assets to current liabilities; or, to state the same thing in other terms, the less need be the working capital of the concern. It is clear that if working assets consist exclusively of cash, all the requirements of safety would be met if these assets were equal to the current liabilities. In other words, a concern with perfectly liquid working assets, need have no working capital. The nearer a company approaches to this condition, the smaller is its requirement of working capital; consequently, it follows that any measures which can be taken to increase the liquidity of such assets as inventories and accounts receivable will make possible a corresponding saving in the sum that must be set aside for working capital.

There is no method of increasing the liquidity of stocks of merchandise except care in manufacturing or in purchasing only stocks that are readily salable. No one outside the business itself can be of much assistance in securing this result. Accounts receivable, however, constitute an asset that can be transferred and, inasmuch as most of these accounts are automatically at some later date converted into cash they furnish an excellent collateral for preliminary advances of cash.

Within recent years a large business has been built up by a number of financing corporations which make it their chief business to make advances against instalment accounts receivable and commercial accounts receivable, thus enabling the firm which owns such accounts to convert them wholly or partially into cash before they have come to maturity.

In European practice financing corporations of this type are unknown and unnecessary, for most sales of merchandise are represented by accepted drafts (more commonly known as "trade acceptances") which the selling firm may discount at its own bank or may sell in the open market. In the United States, however, the custom prevails of granting "lines of credit" at banks; these lines of credit are based in large part on the concerns' showing of a satisfactory proportion of working assets to current liabilities and the bank does not favor any method of anticipating the normal conversion of current assets into cash or of pledging any of the current assets. It has, in fact, grown to be an accepted principle, which many bankers perhaps fail to apply with sufficient discretion, that all current assets must be kept free and unincumbered; otherwise the bank will not care to extend credit.

In spite of opposition on the part of the banks, the financing corporations have rapidly increased the volume and raised the character of their dealings. Moreover, certain banks and trust companies have gradually come to carry on a limited amount of business of the same type.

There are two distinct fields of operation for the financing corporations that have been referred to, and they are readily divisible into two corresponding groups: The first group confines itself almost entirely to making advances against instalment accounts receivable, and the second group into making advances against commercial accounts receivable. The chief kinds of instalment accounts handled in this manner are those which arise in connection with the sale of agricultural machinery, pianos, and other musical instruments. Both these lines of business are conducted by large and well-established corporations which do a national business, in some instances making sales direct to consumers and in others making sales through dealers to whom they frequently give assistance in financing their business. For reasons that have been fully

explained above, the amount of capital that would be required to finance an instalment business of any size would be prohibitive to most retail dealers if they were to work unassisted. Publishing companies which sell dictionaries, encyclopedias, and other sets of books, payment for which is made by instalments, also frequently secure advances, using their accounts receivable as collateral; for various reasons, however, this class of instalment accounts is not ordinarily regarded with so much favor as the other classes that have been mentioned.

As typical of the manner in which the financing corporations that handle instalment accounts operate, we may take the published description issued by the Commercial Security Company of New York and Chicago, which makes advances on the strength of notes, mortgages, and leases given by purchasers of pianos to dealers and manufacturers. The company deals only with concerns which furnish satisfactory financial statements and have a good commercial rating. This concern must guarantee all the instalment accounts, leases, or notes which are assigned to the Commercial Security Company as collateral. The accounts (which may be in the form of leases or of notes secured by mortgages) are not actually taken over by the Commercial Security Company, but are left in charge of some one in the employ of the dealer or the manufacturer who is authorized to make collections and who is bonded to make prompt payment of the proceeds to the Security Company; the former custom of transferring the accounts bodily to the financing corporation which made its own collection has proved objectionable and has been almost entirely abandoned. The Commercial Security Company requires that final instalments on the paper which it accepts as collateral must mature within 31 months, and that at least 20% of the price of the piano must have been paid, leaving 80% of the price to be collected. Against this balance the Commercial Security Company makes advances to the extent of 80%; in other words,

the maximum advances are equivalent to 64% of the retail price of the pianos. The Commercial Security Company then deposits the paper which it has accepted as collateral, with certain designated trust companies in New York and Chicago, and issues its own 6% bonds up to 80% of the face value of the paper which it has deposited. These bonds (which might better be called "serial notes") are issued in series of \$100,000, \$10,000 maturing every three months, so that each issue is paid out within 2½ years. The bonds are sold to banks and to the general public, and are said to be well regarded as a good type of short-terms notes.

The Agricultural Credit Company, which was incorporated in New York in 1912, operates along much the same lines, except that it specializes in the notes or other obligations given in payment for agricultural implements. A number of other companies might be mentioned.

In making advances on commercial accounts receivable, the Manufacturers' Commercial Company of New York follows much the same plan that has just been described. This company purchases the accounts receivable of mercantile firms and deposits the paper which it purchases with a trust company as collateral for its own issues of collateral trust certificates. These certificates bear 5% interest, maturing in from 30 days to one year and are in amounts of \$100 or any multiple thereof. They are sold both to banks and to private investors. The company carries a 20% margin of collateral. On April 1, 1914, according to the company's published statement, the total collateral held by the trust was in excess of \$800,000 based on 1,073 accounts, showing an average amount of \$795.22 in each account. The company features the widespread distribution of risk due to the small sum represented by each account. Most of the financing corporations, however, which handle commercial accounts receivable, themselves reassign the paper which they take over, with their own indorse-

ment, to the banks with which they do business. They make a point of the fact that accounts or notes can be assigned and yet the collections may remain in the hands of their clients, thus insuring that the assignment is kept confidential.

The Commercial Credit Company of Baltimore advertises that manufacturers and jobbers may sell to them \$200,000 of notes during any year, at a total cost of \$2,500, provided they are paid within 30 days. Inasmuch as this is at the rate of 1% per month, plus a commission charge of $\frac{1}{2}\%$ on the first \$100,000 of accounts, it is clear that the rate of discount which the manufacturer or jobber must pay is high; yet the accommodation that he receives may be well worth the discount.

These companies usually loan up to about 75 to 80% of the face value of the paper which they accept as collateral. Sometimes a fixed line of credit is granted to a client, against which a corresponding amount of collateral is constantly maintained (paid or bad accounts being continually replaced by fresh ones), and sometimes a separate loan is made against each given block of collateral, each loan being regarded as a new and distinct transaction.

An Unusual Problem

The special problem that we have just been considering—the problem of converting current assets into cash—comes up in nearly all lines of business, and in many different forms. While it is not necessary to consider all possible variations, one problem in this field which is somewhat peculiar and which is also illuminating, may be described. The problem can best be stated in the words of the man who is facing it:

I am engaged in a paving contract for the city of payment for which is given to me, not in cash, but in special tax bills issued against the property along the streets that are being paved. These tax bills are evidence that an assessment has been levied against the property.

They are delivered to the contractor who may make his own collections on certain conditions; or the tax may be paid to the City Treasurer who will transmit it to the owner of the tax bills. The bills bear 7% interest after maturity. In case of non-payment, the owner of these tax bills must, at his own expense, bring suit within two years and, inasmuch as the tax bills take precedence over everything except general state, city, and county taxes, may readily enforce collection. However, suit cannot profitably be instituted until toward the end of the second year, and many property owners who are aware of this fact allow them to run throughout nearly the whole period. The average length of time before the tax bills are paid is about five months.

These tax bills are not readily salable either to bankers or to investors; although they are exceptionally well secured and draw 7% interest, the time of payment is so uncertain that no one desires to have his money tied up in them unless he is compensated by an exceptionally heavy discount, which usually amounts to 10%.

On the other hand, in my contracting business I need to turn over capital quickly, and find that tying up money in these slow bills cripples my capacity to handle work.

Here is a problem that is unusually difficult because of the non-commercial character of these tax bills, and also because of their uncertain maturity. It was suggested that the only solution in this case is to use the tax bills as collateral for notes either to be discounted at banks or to be sold to private investors. It would be necessary that the arrangement as to collateral should be sufficiently elastic so that as rapidly as some of the bills were paid off, others would be substituted. The contractor would then be able to give his personal notes of a definite date of maturity and, in case the tax bills were not paid with sufficient promptitude to meet the notes, he would then have left the recourse of selling the remaining tax bills at a heavy discount, thus enabling him to take care

of his own notes. At the worst, this method should be less expensive than the usual method of selling the notes outright. Unless there were some unexpected failure on the part of a number of taxpayers to meet their obligations, the contractor would probably be able to borrow funds required in his business at no more than the usual bank discount rates. It is understood that this suggested course of action has been followed and that by this method of converting some of his current accounts into cash the contractor has been able to proceed with the normal development of his business.

Working Capital to Provide for Seasonal Variations

A great many companies work under the handicap of extreme variations in the amount or the character of their business from one season to another. This was formerly true, for example, in the automobile business. During the early period of the popularity of pleasure vehicles the great mass of sales were made in the spring and early summer of each year; it is reported that in this industry the seasonal variation is being much reduced. Manufacturers of rubber goods, especially rubber shoes, find their sales concentrated at certain seasons; the same thing is true of manufacturers of agricultural implements, of sporting goods, and of many other products that will readily occur to every one. Manufacturers of textiles, of beet sugar, and of other products made from raw materials gathered from the soil are under the necessity of buying heavily at certain seasons of the year in order to secure the benefit of minimum prices. In all these lines of industry, either large stocks of finished products must be accumulated during the remainder of the year in order to meet the requirements of the busy season, or large stocks of raw materials must be purchased at a given season and gradually used up during the remainder of the year. In either case it is clear that much larger sums of money must be tied

up in working assets during certain periods than during other periods of the year. This is a situation that involves unusual difficulties and greatly affects the amount of working capital that is required. The usual method is to secure a gradually increasing amount of bank loans as finished products are accumulated which are rapidly paid off during the sales season; or, if the other situation prevails, a large loan is effected during the buying season which is gradually paid off during the remainder of the year. Dependence upon bank loans exclusively, however, is unsafe, as many companies have discovered. Textile manufacturing companies have been peculiarly subject to failure because of their inability, owing to some unforeseen contingency, to meet the obligations held by their banks. Some years ago, when the so-called "Sugar Trust" desired to obtain control of an important beet sugar refinery, it is alleged to have obtained this result by secretly buying up all the short-time notes given by the sugar refinery during its purchasing season and then demanding prompt payment of these notes instead of granting the customary partial renewals. As a result, the prosperous refinery suddenly found itself confronted with the prospect of bankruptcy and was forced to surrender.

Although it would not be economical for companies engaged in seasonal industries to keep themselves supplied with the amount of working capital that is required at the maximum period of each year, it is highly desirable and prudent that they should carry a much larger working capital than would be required during the off seasons. This is a part of their normal expense of doing business. Such companies sometimes find it advantageous to invest their surplus cash reserves during the off seasons in short-term securities.

Month-by-Month Calculations

It was remarked at the beginning of this chapter that it would be impracticable to attempt to draw up any invariable

formula for calculating the amount of working capital required in any given concern. We must content ourselves with the general statement that working capital requirements vary roughly in proportion to the volume of business, the length of period of manufacture, the average length of credit extended to customers, and the extent of seasonal variations in volume of business, and that they vary roughly in inverse proportion to the rapidity of turnover, length of credit obtained in purchases of goods, and the facilities available for converting current assets into cash. These are the factors to be taken into account.

Inasmuch as the customary unit of time used in reckoning most commercial operations is the month, it is worth while, in all close thinking and figuring as to the working capital requirements, to make estimates on a month-to-month basis. An estimate of this nature relating to a hypothetical case of a house doing an instalment business has already been given and will serve as an illustration of the method that should be followed in making up all such estimates. If all the factors that have just been named are known, and assuming in addition that the various costs of manufacture or of purchase, selling, overhead administration, and the like are known, there will be no difficulty in figuring out just what the cash outgo and cash receipts of each month will amount to. This will show the working capital requirements month by month. By adding a liberal margin to cover faulty estimates and contingencies, the approximate amount of working capital required, even for a new corporation, can be estimated. In the case of an established corporation, which has behind it years of experience and of records, the information that is desired can be worked out with greater accuracy.

CHAPTER XVIII

DETERMINATION OF NET INCOME

Formula for Income

The chapters preceding have dealt with such subjects as the financial forms of business enterprises, the various types of shares and of obligations that may be issued, the selection of securities that are adapted to all the needs of the corporation and to the security market, the construction of a correct financial plan, the promotion and initial financing of a new enterprise, the various methods of selling securities and thus raising the capital required, and the principles which determine the investment of that capital in fixed and in working assets. This completes our study of the various stages in the creation and financial organization of a concern. The remaining chapters deal with the management of companies that are already established and with the exploitation and reorganization of companies that are unfortunate or mismanaged.

The first questions that arise in the financial management of a going, profit-making concern have to do with the determination and distribution of its income. The determination of income may be regarded as primarily a problem of accounting, but it is also a financial problem. As was pointed out in Chapter I, the line of distinction between financial and accounting questions is not always to be sharply drawn. We will not be trespassing, then, on the exclusive territory of our friends, the accountants, if we take up for brief review the question of how corporate income is and should be determined.

For purposes of illustration the following two statements of income are reproduced. The first from a recent report of the American Locomotive Company is in the following form:

Gross Income	\$29,987,438
Operating Expenses, Including Manufacture, Maintenance, and Administrative Expenses and Depreciation Charge	27,425,187
Net Income.....	\$2,562,251
Interest, Taxes, and Other Fixed Charges	486,124
Surplus for the Year.....	\$2,076,127
Preferred Dividends	1,750,000
Surplus Available as Earnings on Common Stock.....	\$326,127
Equivalent on Common Stock to.....	1.3%
Dividends on Common Stock	
Carried to Surplus Account	\$326,127

A much more detailed income statement is that of the Union Pacific Railroad Company, which is as follows:

Freight Revenue	\$59,253,344
Passenger Revenue	18,817,047
Mail, Express, and All Other Transportation Revenue...	6,726,317
Incidental Revenue	2,161,587
Total Revenue	\$86,958,295
Maintenance of Way and Structures.....	\$10,900,925
Maintenance of Equipment	12,101,212
Total Maintenance	\$23,002,137
Traffic Expenses.....	2,061,971
Transportation Expenses	23,108,140
Miscellaneous Operations Expenses	1,313,189
General Expenses	2,811,421
Transportation for Investment— <i>credit</i>	160,148
Total Operating Expenses	\$52,136,715
Taxes	4,641,474
Total Operating Expenses and Taxes.....	\$56,778,189

DETERMINATION OF NET INCOME

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Revenues Over Operating Expenses and Taxes.....	\$30,180,106
Other Operating Income	1,276,138
Total Operating Income	\$31,456,244
Fixed and Other Charges	15,028,285
Surplus from Transportation Operations After Deduct- ing all Fixed and Other Charges.....	\$16,427,959
Income from Investments and Other Sources.....	11,964,064
Total Surplus	\$28,392,023
Less Dividend on Preferred Stock at 4% Per Annum....	3,981,740
Surplus After Deducting Dividend on Preferred Stock..	\$24,410,283
Equivalent on Common Stock to.....	10.98%
Amount Required to Pay Dividend on Common Stock at Rate of 8% Per Annum.....	\$17,783,328
Surplus After Deducting all Fixed and Other Charges and Dividends on Preferred and Common Stock.....	\$6,626,955

The above examples show the essential steps in calculating income, which are as follows:

1. State gross earnings.
2. Deduct operating or manufacturing expenses, including selling, administrative, maintenance, and depreciation.
3. The result is net earnings from operation.
4. Add income from other sources.
5. The result is total net income.
6. Deduct taxes, interest, rentals, sinking fund charges, and other fixed charges.
7. The result is surplus for the year applicable as earnings on shareholdings.
8. Deduct preferred dividends.

9. Deduct common dividends.
10. The result is surplus from the year's operations to be credited to surplus account.

It seems hardly worth while to point out that income and expenditure are by no means identical with cash receipts and cash disbursements, though this elementary distinction is not always grasped, even by learned judges and lawyers. It has been pointed out, for instance, by an English authority, that among the legal judgments which have been delivered in the courts of the United Kingdom are such absurdities as the following:*

Profits for the year, of course, mean the surplus in receipts after paying expenses and restoring the capital to the position it was in on the 1st of January in that year.

Fixed capital may be sunk and lost and yet the excess of current receipts over current expenses may be applied in payment of a dividend.

It has been only a few years since the Attorney-General of the United States interpreted the law imposing a tax on corporate income, which had just been passed by Congress, as meaning that a tax had been imposed on the cash receipts minus cash disbursements. His decision was promptly overruled, but among accountants it has not been forgotten.

Honesty in Stating Gross Earnings

In connection with the preceding paragraph, it must be admitted, however, that the conception of the word income as referring only to net cash receipts, has the advantage of being much simpler than the present significance of the word. Income as understood in modern business includes all the various kinds of realized gain from operations during a given period. This gain may be realized in the form of increased

*Francis W. Pixley, "Auditors: Their Duties and Responsibilities," pp. 515-517.

accounts receivable, enlarged facilities for production, reduced obligations, or in various other ways. Inasmuch as the extent of the gain is frequently difficult to measure, there is left considerable latitude for the exercise of discretion and good faith on the part of officials in estimating income. It is sometimes possible for them, if they are not governed by the strictest integrity, to stretch or reduce the statement of income which they give to their stockholders and to the public in order to serve their personal interests.

In the first report of the United States Realty and Construction Company, earnings for the nine months' period ended June 30, 1903, were given as \$1,417,000; but it later appeared that \$487,000 of these earnings consisted of "profits from estimated increase in the value of investments still held" and \$577,000 consisted of "profit on buildings in progress, estimated proportion accrued." The first item is typical of a practice that is frequently advocated by corporate officials who desire to make a showing of profits that have not been earned through operation. Real estate, securities, stocks of merchandise, and the like are constantly fluctuating in value. If any of these properties is actually sold and a profit is realized, it is entirely proper that this profit should be credited to surplus, but it should certainly not be credited to the surplus arising out of operations during a given period. So long as the profit is not realized, but exists simply on paper, it is almost universally agreed that it should not be credited at all. Officers who advocate marking up profits on account of fluctuations in value of permanent holdings are frequently the first ones to find some plausible reason for declining to mark down profits when these same holdings decline in value. If a company is engaged in the business of buying and selling real estate or securities, the case may be different and may be worthy of further consideration, but in other cases such profits should not be credited unless realized.

As to the second item, there is undoubtedly more room for debate. It would seem unfair that companies which customarily engage in long-time contracts, such as the construction of buildings and the like, should credit no profits to the period in which the construction work is going on. On the other hand, it was found in the case of the United States Shipbuilding Company that the anticipated profits on large contracts, which had been counted in the millions of dollars, were never realized, but actually turned into a loss at the completion of the contracts. Estimates of profits on uncompleted contracts are likely to be made by officers whose judgment may be warped by their own interests. Such items are to be considered, therefore, with some degree of skepticism.

A curious difficulty of accounting in arriving at gross profits is illustrated in the financial history of the American Malting Company. It appears that in the malting process each bushel of cleaned barley produces 112 to 115% of a bushel of malt. This increase is a normal incident in the process of manufacturing malt and it is claimed should be taken into consideration as a source of profits. It is, however, at least questionable whether anticipated profits from this source should be counted. It probably is time enough to count them when the profits have actually been realized.

Another fruitful source of error in stating gross earnings is overoptimism in the valuation of finished and partly finished products and raw materials on hand. Sometimes balance sheets are found in which inventories amount to several times the aggregate of gross sales. In such cases it is clear that even a slight excess valuation of the inventories may be the real source of a considerable proportion of the alleged profits. Where the item of inventories appears to be constantly growing, from year to year, more rapidly than sales and profits, the estimate of gross earnings should certainly be subjected to close examination,

At the formation of the American Bicycle Company in 1898, the constituent plants were taken in largely on the basis of their reported net earnings. From later developments and analysis it seems probable that these net earnings were in many cases overstated, by reason of the fact that inventories of dead stock which should have been charged off to profit and loss were carried at their full valuation.*

It should never be forgotten that, by reason of the discretion which is necessarily accorded to them in estimating gross earnings, corporate officials ought to be exceptionally conservative, and for their own protection should rely to a great extent upon the judgment of impartial accountants and other outside advisers. Misstatements of gross earnings are not made necessarily with dishonest intentions; the men who are most interested in the business are frequently the very ones who are most easily persuaded that an exaggerated estimate of unrealized earnings is sound and reliable.

Operating Expenses and Deductions

There is usually little question as to the actual outgo for raw materials or other purchases, labor, selling expenses, salaries of officers and other administrative overhead, etc., all of which are directly chargeable to the various accounts that are grouped under the general heading of "Operating Expenses." Even here, claims are sometimes advanced in favor of charging such expenditures as for advertising and for training employees, to capital accounts rather than to operating expenses, on the theory that such expenditures are a permanent benefit to the business. If such claims are to be allowed at all, which is usually doubtful, it is regarded as correct practice to charge items of this nature to some such account as "Deferred Expenses," which is carried on the balance sheet for the time

*The illustrations in this section are, for the most part, taken from Dewing's "Corporate Promotions and Reorganizations."

being as a capital account but is intended to be written off within a brief period.

There is little, if any, question also as to most expenditures for repair and maintenance of the permanent property of the business. This property must be kept up as nearly as possible to its original standard of efficiency, and the expense of so doing can scarcely be regarded otherwise than as a portion of the total expense of operation. Going a step farther, it is well to point out that many new companies make a serious error in that they do not at once begin to charge against profits a fair allowance which will take care of at least a portion of the repairs and other maintenance expenses that are to be expected in the course of a few years. Owners of apartment houses and other city real estate are frequently negligent in this respect to their own detriment. A building of this character may run for some years with comparatively slight outlay for repairs; then all at once everything is out of order. Either large sums must be expended and charged against operating expenses or the character of the building will change for the worse and a lower income will be obtained. The same line of reasoning applies to many manufacturing establishments. Electric railways up to the present time have not, on an average, consumed nearly so large a ratio of their gross earnings in maintenance as do steam lines. Whether the ratio will later become larger is an undecided question, but perhaps it may reasonably be assumed that it will increase. Unless provision is made in advance, the results cannot be pleasing to shareholders in such companies. The subject of maintenance and repairs will be again referred to a little farther on in this chapter.

Reserves

Nearly all well-managed corporations charge against the profits of each year an estimated sum, or a number of distinct

estimated sums, which are intended to provide for losses and expenses that will probably arise in the future but which are incident to the operations of the current period. The sums so charged are credited to reserve accounts, which are carried on the balance sheet of the company. As to the nature and use of these reserve accounts, there is much misunderstanding. They do not consist, as people seem sometimes to imagine, of funds of cash or property set aside for the purpose of meeting future expenses. It is, in fact, easily possible that a company may accumulate large reserve accounts and yet be quite unable to meet the anticipated expenses when they actually arise. The essential character of all reserves lies in the fact that they constitute a deduction from profits. The reserves exist only in the form of entries and figures in the company's books of account. It is quite possible that a firm which carries no reserves on its balance sheet may be just as conservatively managed as the one which has large reserves. But the probabilities are the other way, for the reason that proper estimates in favor of reserve accounts assist the officers and stockholders of a company in gauging the true status of the business and therefore discredit exaggerated optimism.

The most common form of reserve is that for depreciation in the value of fixed assets, due to wear and tear, obsolescence, etc. Depreciation on account of wear and tear may be estimated in advance with some accuracy, but depreciation for obsolescence is always of uncertain amount. No one can foresee what changes in taste or fashion, what unthought-of inventions, or what improvements in organization may take place, which will perhaps render useless, or partly useless, much of the company's plant, machinery, or other assets. The best that can be done is to make a fairly liberal estimate, based on the experience of the past and trust that it will be sufficient to keep the book value of fixed assets always well within the limits of actual value. If this result is not accomplished, then

the depreciation reserve is insufficient and net income is overstated.

Although the presence of depreciation as an actual factor in every business can scarcely be denied, yet the absence of any depreciation charges and reserve accounts on the books of certain corporations is defended by fallacious arguments. For example, many street railway companies and other public utility corporations decline to make any deduction for depreciation charges from gross income. The claim which many of them advance is that the value of their franchises is constantly increasing and is sufficient to offset the admitted decline in value of their road-bed and equipment. This kind of argument is apparently advanced simply to justify a line of action previously determined upon. It is based upon a two-fold fallacy. First of all, granting that there is a steady rise in the value of the company's franchises and that this rise should be taken into the income account, it should then be valued by itself and shown as a source of income, while depreciation charges should be shown as a deduction from income; otherwise there is not even an attempt to make up a fair and reliable income statement. In the second place, experience has by this time shown that the alleged increase in the value of franchises is a highly uncertain factor. Most public utility enterprises are subject in a peculiar degree to legislative control and the legislature usually takes care that franchise values are not permitted to increase with excessive rapidity. The better managed public utility companies are gradually falling into line and are forming adequate depreciation reserves.

Another fallacy is clearly seen from the last annual report of the Canadian Locomotive Company, which includes this remarkable assertion: "We have not added anything to depreciation reserve account as we feel that, our plant being new, the \$75,000 already at the credit of this account is sufficient."

Following out the line of reasoning of the directors of this company, it is evident that depreciation reserves are to be set aside only when the period has arrived in which they are actually needed. This makes the so-called depreciation reserve and the account for repairs and maintenance, practically identical, and does away with the only genuine reason for the creation of a depreciation reserve. The London *Economist* has put the truth of the situation clearly in the following words: "Depreciation allowances are all the more necessary in a boom period, because there is always the practical certainty that the boom will decline more or less suddenly and will leave overvalued stock on hand." Companies that have new plants and are enjoying prosperity are the very ones which should be setting aside liberal reserves for depreciation.

It is not intended in this last sentence, however, to suggest that the practice of writing off depreciation reserve irregularly by arbitrarily setting aside such sums as can conveniently be spared out of the annual surplus, is one to be encouraged. This practice is followed, it is true, by some of our greatest and best-managed concerns, notably by the United States Steel Corporation. But it is essentially unsound. Depreciation is not a theory or a vague notion in some one's head; it is an actual element in the operation of every business; it is going on night and day; through all seasons; year after year; in periods of depression as well as in periods of prosperity. The losses due to depreciation should constitute, therefore, a regular charge against gross income. The amount of that charge should be estimated as accurately as possible and should be adhered to year after year; otherwise we get a purely fictitious showing of net profits. If large sums are charged off in one year and nothing is charged off the next year, the final showing of profits in the two years may be about uniform, whereas the business has perhaps really suffered an enormous fluctuation. The purpose of accounting should be,

not to conceal such facts, but faithfully and clearly to set them forth.

Depreciation of intangible assets, as well as depreciation of plant, road-bed, equipment, and the like, should be liberally estimated and provided for. In fact, it is generally agreed that the practice should be to "write off" intangible assets at an especially rapid rate, even though their real value may not be decreasing. Many bankers and other financial men have a very high regard for what is called a "clean" balance sheet, that is to say, one which includes only tangible assets at their cost value with ample depreciation reserves. This preference seems to be in many cases little more than a prejudice, inasmuch as such assets as patents, copyrights, goodwill, and the like may be permanent and productive, and may properly be carried as real assets. Nevertheless, even where this is the case, it is often advisable to cater to the prejudice that has been created through the unscrupulous and reckless valuation sometimes placed on intangible assets, and to carry out the policy of "writing off" with considerable rigor. One company which follows this practice is the Eastman Kodak Company, which carries depreciation reserves of over 25% against its book valuation of "properties, patents, goodwill, etc."

There are many other kinds of reserves which should be carried if the business of a company is to be based on sound accounting and finance. The business of many companies, for example, requires them to enter into contracts which involve immediate payment on the part of the purchaser of their products, combined with a liability assumed by the company to render future service. A company publishing a magazine usually collects subscription payments in advance and contracts to deliver the magazine over a twelve months' period. This being the case, it is clear that the company actually earns the subscription payment only as it proceeds through the

year with the delivery of its magazine, and that it would be improper to credit the subscription payment as income of the week or month in which it is received. The modern custom among magazine publishers is to credit an account usually called "Unearned Subscriptions" for payments sent in by subscribers, and at the close of each month to debit this account and credit another account called "Subscription Earnings" for the proportion actually earned by sending out magazines during that month.

Various asphalt paving companies include in their paving contracts guarantees to keep the streets which they pave in repair for a certain number of years. At first the guarantee was usually 5 years, which in New York was extended to 15 years, and in some other cities to 10 years; later the guarantee period was gradually reduced to from 2 to 5 years. At the time when the guarantee system was first introduced, insufficient reserves to cover expenditures under these guarantees were set aside, and consequently profits at this stage were greatly overestimated. During 1899 the accounting methods of the Barber Asphalt Paving Company showed a nominal profit of \$474,000. Later, the Audit Company of New York estimated the actual profits to have been \$35,700. Most of the discrepancy between the two figures was due to the fact that the company originally failed to set aside sufficient reserves to enable it to meet its guarantees.

Future outgo on contracts that are taken into current income account should be watched and provided for with the greatest care. Companies that are conservatively managed will look out for future or contingent expenses of this kind. In a recent balance sheet of Babcock and Wilcox, for example, one item consists of "Reserves for further estimated expenditure on orders invoiced." An account under some such title should be included on many other balance sheets where it is now missing.

Operating Expenses and Betterments

We have spoken above of charges for repairs, renewals, maintenance, and depreciation as being properly included in operating expenses or in deductions from gross income, and have emphasized the necessity for liberal allowances. There is, however, a possible, although not so frequent, danger of going to the opposite extreme. Depreciation charges may be too high, and thus the showing of earnings may be unduly depressed. Boards of directors sometimes find it to their advantage to see that reports of low earnings are given out to stockholders and to the public over a given period, so that they may take advantage of this misinformation to buy up the company's shares at bargain prices.

Again the various accounts included under the general headings of "Repairs," "Renewals," and "Maintenance" may be stretched so as to include outlays for betterments. In this case earnings are apparently depressed and the capital accounts remain stationary although the capital assets are at the same time being built up. Something of this kind has happened most frequently in the management of railroad companies in the United States. Conservatively managed companies have frequently included in their "Maintenance" accounts, expenditures for reballasting, for laying heavier rails, for putting in permanent culverts and even bridges and for purchasing new locomotives and cars. After this practice has been carried on over a period of years and the property has been put into excellent condition, the statements of earnings are allowed to expand to their correct proportion and the stockholders of the second period are perhaps given enlarged dividends or a "melon" of some kind.

A notable instance is the Lehigh Valley Railroad Company under the management of President Walter from 1898 to 1904. During these six years the stockholders noted in each year's accounts that the charges for maintenance, repairs, etc.,

were growing to unprecedented heights and that the net profits were correspondingly reduced. They suspected the truth—that expenditures for betterments were being charged into maintenance accounts—and many of them protested, but without effect. After the close of the Walter régime, the property was found to be in remarkably good condition and the subsequent financial history of the Lehigh Valley has been one of progress and good earnings.

Is Concealment of Betterment Expenditures Advisable?

The management in the Lehigh Valley case, and in many other similar cases, took the attitude that they were the ones best acquainted with the needs of the corporation and were better entitled than were the stockholders to judge as to the necessity for betterment expenditures. They believed, further, that stockholders, if the decision were left to them, would not have sufficient patience or be sufficiently interested in the development of the corporation to be willing to have large sums set aside out of each year's earnings in order to build up the capital assets. It might have been possible, to be sure, to finance the required betterments by fresh issues of obligations and of stock, but the management believed that in view of the past financial record of the company, this could not be economically accomplished. They took, therefore, the course which seemed to them proper, of concealing—or partially concealing—the expenditures for betterments, and thus improved the property of the corporation without the knowledge or consent of the stockholders.

The motives of the management in this case were unimpeachable, and there can be no doubt, as we look back, but that the Lehigh Valley and its stockholders as a body have been greatly benefited by the policy that was followed. And yet this conclusion may not dispose of the whole question.

The stockholders of most large corporations at the pres-

ent time can scarcely be regarded as a permanent body of individuals. Shares are constantly being shifted back and forth in the stock market; many shareholders do not regard their holdings as permanent assets, but rather as temporary investments which they intend to sell whenever they may need money. Naturally, each set of stockholders desires to secure as large returns as possible, and emphatically does not desire to have earnings secretly withheld in order that future stockholders may reap the benefit. Their first interest, usually, is not in the corporation, but in themselves. And we must face the situation that actually exists in many large corporations in which the interests of the stockholders and the interests of the corporation are not quite identical. Under these conditions, which set of interests shall the directors elect to serve? Withers quotes, with full approval, the opinion which is forcibly, though dogmatically, expressed by Pixley, as follows:*

It is not incumbent upon the directors to consider in any way individual shareholders, or a special group of shareholders, and certainly not those who make a practice of buying and selling shares and holding them for short periods. It is their duty to keep the capital of their company intact, and to do their best to make it a permanent institution.

Equally forceful and dogmatic opinions are often expressed by shareholders on the other side.

Perhaps the most practical conclusion that can be reached is that the directors should consult both sets of interests and, when necessary, should compromise. Certainly they should protect and keep intact the property of the corporation. But in so doing they should endeavor to avoid injurious concealment of facts or injustice to one set of shareholders as com-

*Pixley's "Auditors: Their Duties and Responsibilities," quoted in Hartley Withers' "Stocks and Shares," p. 156.

pared with the succeeding set. In case the corporation openly withholds dividends and piles up a surplus, shareholders know what is being done and the market prices of their holdings respond to the true status of the company's assets. This was demonstrated over a period of several years by the Reading Railroad Company, the shares of which were paying 4%, yet for years were sold at between 120 and 150. The question is not whether the accumulation of a surplus out of earnings is advisable, but whether *concealment* of the accumulating surplus is advisable. Without failing to recognize the force of the argument that can be advanced in favor of concealment, it would seem that the reply to this last question should, on the whole, be negative.

In those not infrequent cases where directors are with reason suspected of deliberately withholding and concealing earnings and piling up a secret surplus in order that they may, as individuals, profit at the expense of their fellow shareholders, there is, of course, no room for differences of opinion. This last case is simply one of exploitation.

Two Classes of Betterments

Before leaving this subject, it may be well to call attention to the two different classes of betterment expenses which are generally regarded as being properly financed in two different ways. One class consists of betterments which are certain to yield a definite, traceable return, either in the form of enlarged revenue or in the form of savings in outgo. When a railroad company, for example, decides to construct a tunnel and straighten out its line between two given points, it should be readily possible to calculate not only the cost of the betterment, but also almost the exact amount of savings that it will effect in fuel, labor and the like. When a manufacturer puts in a new piece of machinery in order to turn out a better grade product, he should usually be able to calculate how large will

be the increase in the price and total sales of the new product.

The second class of betterments consists of those which are considered desirable and well worth the expense involved, but which will not yield direct and traceable profits. A department store, we will say, decides as a matter of business policy that it should build and furnish a handsome recreation and lunch room for its employees. The officers are satisfied that the result will be to increase loyalty, interest, and efficiency, and thus indirectly build up the store's prestige and increase its sales. Nevertheless, it will be impossible to arrive at a mathematical calculation of these results. The directors of a bank decide that they will put up a fine new building which will constitute the best kind of a standing advertisement of the bank's stability. Much of the cost of the building, however, will not be represented by any adequate return on the invested capital, and must be regarded, therefore, as a betterment which does not yield traceable results.

By general consent among the officers and directors of great corporations, it is agreed that the first class of betterments may properly be financed by the issuance of fresh securities, if it can readily be shown that the interest or dividends on these securities will be provided out of the enlarged income or the savings made possible by the betterment. The second class of betterments, however, should be provided for out of surplus. They may prove to be highly profitable, but there is no certainty on that point. The only money that should be spent on them, therefore, should be money that has been accumulated out of the profits of the preceding years or that is currently accumulating. In case the judgment of the directors should be wrong, and the betterments should not make for enlarged profits, the corporation would at least escape a loss that would be damaging to its credit.

The Pennsylvania Railroad Company has, perhaps, been

the most consistent follower of the principle that has just been presented. In financing \$150,000,000 of improvements of the company in New York City terminals, including tunnels under the North and East rivers and the magnificent terminal building, approximately one-half the investment was provided by fresh issues of securities; the other half was provided by charges against the surplus of the Pennsylvania Railroad and allied companies.

Another clear-cut example is furnished in the announcement of the London and South American Railroad Company, which in October, 1914, brought out an issue of £1,000,000 5% redeemable preference stock. According to the *London Statist*, it was announced that the proceeds were to be used for electrifying certain sections of the suburban systems of the company:

The decision was come to that it would not be right for the whole cost of the work to be charged against capital; it was realized that to some extent the adoption of electric traction is in reality an alteration in the method of working; the one kind of traction merely being substituted by another: Therefore, it was decided that only the cost of the power-house, substations, and the third rail, should be charged against capital account, and that other items, such as alteration of the rolling stock and structures, the bonding of rails, and the various other expenses, should not be a permanent charge upon the revenue of the company.

Too many companies rush ahead blindly in making whatever betterments appeal strongly to the operating officials, without giving sufficient thought to the soundness of their methods of financing the betterments. One of two results is almost certain to follow; either the company provides the fresh capital required too largely by the issuance of securities which may in time become a dangerous burden; or the ex-

penditures for the betterments are unjustly saddled upon the shoulders of those who happen to be shareholders at the time and who are deprived of a portion of the earnings to which they feel rightfully entitled. In this latter case, the policy may be followed either openly, by making direct charges against surplus, or secretly, by including expenditures that are really for betterments under operating expenses.

All these courses of action are objectionable. The real solution is to be found in the careful division of the betterments into the two classes that have been named and in the selection of corresponding methods of financing. In this case it will probably be comparatively easy to convince shareholders that they should be willing to sanction reasonable charges against surplus to pay for betterments of the second class, and it will not be necessary to conceal these betterments in any form. In that case, assuming also that the gross earnings of the company are carefully and honestly stated, and that operating expenses include all the charges for depreciation and other reserves that should be made, the result will be to arrive at an accurate and just determination of net income.

CHAPTER XIX

DIVIDENDS

Net Income and Dividends

After the amount of a corporation's net income has been determined, it is in order for the directors to consider how it shall be distributed. As was indicated in the preceding chapter, net income is distributed normally through three channels, which are respectively labelled: fixed charges, dividends, and additions to surplus.

As to "Fixed Charges" there is little that needs to be said at this point. They consist of taxes, payments on leases and rentals, and interest payments on the funded obligations. The amount of fixed charges (except for taxes) is determined by the amount and form of the company's capitalization and of its long-term contracts. We have already given consideration to the problems involved in drawing up a financial plan and in deciding what, if any, bond and note issues shall be put out. At the time when net income for a given period has been determined and its distribution is under advisement, the payments for fixed charges are no longer questions within the discretion of the directors or of any one else connected with the company. Unless they are paid as they become due, the company will at once cease to be solvent. We will assume, therefore, that net income is more than sufficient to meet fixed charges, and that there is remaining a balance available for dividends and surplus.

As to the distribution of this balance between dividends and surplus, the board of directors is the sole authority. Neither officers nor stockholders, as such, have any voice

in the matter and there are few effective legal restrictions. We have before us, then, for treatment in this and in the following chapter, the two closely related questions:

What principles should guide the directors in fixing dividends?

What principles should guide the directors in accumulating and in using surplus?

Two classes of dividends are to be considered: those which are preferred and cumulative (with which may be included so-called interest on income bonds), and those which are common or ordinary and have no special priorities.

As to preferred dividends, much the same reasoning applies as has just been stated with regard to fixed charges. There is left, to be sure, a much larger measure of discretion to the directors, who may, at their option, decide to defer the payment. But there is a corresponding penalty in the fact that the accumulated dividends constitute a growing barrier in the way of common dividends, and that the credit of a corporation is adversely affected by piling up large arrears of preferred dividends. For these reasons corporations that are earning sufficient profits and are in sufficiently strong financial condition, usually pay their preferred dividends without much argument. There are, to be sure, some exceptions to this general statement, but the pressure in favor of payment of preferred dividends, wherever possible, is effective in the great majority of cases.

Preferred dividends which are not cumulative belong in a different class. The interests of the common stockholders, whom the directors usually represent, require that non-cumulative preferred dividends should not be paid until common dividends can also be paid. Hence we may include all dividend charges which have priority, but are not cumulative, under our consideration of common or ordinary dividends.

Average Rates of Dividends

A valuable compilation showing the amount of railway stock in the United States which pays dividends, the percentage of this dividend-paying stock to all outstanding stock, and the average rates of dividends over a period of years, is reprinted below :*

	Amount of Stock Paying Dividends	Percentage of Stock Paying Dividends	Average Rate on Dividend-Paying Stock	Average Rate on all Stock
1900	\$2,668,969,895	45.66	5.23	2.39
1901	2,977,575,179	51.27	5.26	2.70
1902	3,337,644,681	55.40	5.55	3.08
1903	3,450,737,869	56.06	5.70	3.20
1904	3,643,427,319	57.47	6.09	3.50
1905	4,119,086,714	62.84	5.78	3.63
1906	4,526,958,760	66.54	6.03	4.01
1907	4,948,756,203	67.27	6.23	4.19
1908	4,843,370,740	65.69	8.07	5.30
1909	4,920,174,118	64.01	6.53	4.18
1910	5,412,578,457	66.71	7.50	5.00
1911	5,730,250,326	67.65	8.03	5.43
1912	5,581,289,249	64.73	7.17	4.64

It is of especial interest to note that from one-half to two-thirds of the corporate stock outstanding in the United States during recent years has been paying dividends. It is to be presumed that the other one-half to one-third consists almost wholly of common stock which has a relatively small market value. Doubtless this non-dividend paying stock is made up only in part of securities on which the earnings are small. It must include a large proportion of the stock of new or growing corporations which are deliberately reserving their earnings for the purpose of building up the business. It is gratifying to observe the rapid increase during the years 1900 to 1908 in the percentage of dividend-paying stock and in the average rates of return. From 1908 to 1912, the earnings in propor-

*Bulletin 66 of the Bureau of Railway Economics, Washington, 1914.

tion to outstanding stock were not far from stationary. In judging these figures, it may, however, be assumed that a part of the rapid increase in stock from 1900 to 1912 was due to stock dividends or other methods of "watering," so that the actual increase in earnings in proportion to the actual investment of capital has probably been greater than the tabulation would indicate.

In most other countries the showing could not be nearly so favorable. It is clear that under the best conditions capital which is invested in stock takes a considerable risk of going without dividend returns.

Percentages of Earnings Devoted to Dividends

An instructive tabulation of the income statements of about 900 English companies for the year ended July 31, 1914, shows the following distribution of profits:

	Net Profits	Preferred Dividend		Ordinary Dividend		Surplus, Reserves, etc.	
	£	£	%	£	%	£	%
Breweries	2,409,759	486,255	20.2	1,312,820	54.4	610,684	25.4
Gas	856,541	139,729	16.3	887,953	103.7	*171,141	*19.8
Iron, Coal & Steel.	1,533,761	275,244	17.9	669,196	43.5	589,321	38.5
Shipping	770,861	104,895	13.6	326,952	42.2	339,014	44.2
Teas, Rubber, etc.	535,699	31,247	5.7	400,384	75.0	104,068	19.3
Trusts	160,725	25,663	16.0	109,220	67.9	25,842	16.1
Waterworks	62,727	9,357	14.9	45,315	72.3	8,055	12.8
Miscellaneous	3,160,147	945,715	29.9	1,473,991	46.5	740,441	23.6
	<u>9,490,220</u>	<u>2,018,105</u>	<u>21.3</u>	<u>5,225,831</u>	<u>55.2</u>	<u>2,246,284</u>	<u>23.5</u>

*Deficit.

It appears from the above table that preferred dividends received 21.3 of the net profits of these 900 companies; ordinary dividends received 55.2; and the balance added to surplus was 23.5.

It should be noted in passing that the gas companies paid

out in ordinary and preferred dividends, considerably more than their net profits, showing that they drew in this year upon the surplus accumulated in previous years.

The London *Economist* comments on the above table as follows:

As usual the iron and steel and shipping companies have adopted a conservative policy with regard to the distribution of profits to their shareholders. Most of the rubber companies have no preference shares, and prefer to maintain their high dividends at the expense of the reserve funds. A very high percentage of the profits of the water and gas companies goes to the ordinary shareholders, and in the case of the latter large reductions have been made in the amounts carried forward for this purpose.

Although similar compilations for companies in the United States are not available, it is probable that the results would be to show a much smaller proportion of earnings paid out in common dividends and a larger proportion reserved for additions to surplus. The tendency in European countries is much more strongly in favor of paying out the greater portion of earnings in the form of dividends than it is in the United States. Doubtless this is due in large part to the comparative instability of economic conditions in a rapidly growing country. It is due also, however, to the fact that different and in some respects more conservative standards of capitalization and of distribution of income have become established. This is a topic which will be more fully treated in the chapter following. It is in the meantime enough to point out that the statistics of a group of companies, although interesting and of some value as furnishing a standard of comparison, are not likely to prove of much assistance to directors in solving the problem for their own company. There are, however, principles which have been almost un-

consciously worked out through the experience of thousands of corporations, and which are now accepted as sound by most conservative business men. These principles furnish the safest and most satisfactory guide.

Regularity of Dividends Desirable

The principle of greatest practical importance is that regularity in the dividend rate is highly desirable. This principle must be regarded as almost a discovery of the last generation or two. Formerly the unquestioned practice was to regard shareholders as standing in substantially the same relation as partners. They were supposed to be familiar with the status and fluctuations of the business and were expected to share in its ups and downs. If the enterprise enjoyed an exceptionally good year, it was accepted as a matter of course that the dividend rate would be correspondingly increased. If in the following year there was a sharp decline in profits, the dividend rate should be correspondingly cut. As a matter of fact, this is today the practice of a great number—perhaps the majority—of corporations. In so far as it is followed by close corporations, all the stock of which is held by men who are themselves active in the business and familiar with its every phase, it is probably unobjectionable. It is a matter of personal preference in many cases, and has the advantage of stimulating the interest of those shareholders who are active in the business to the highest degree.

But the corporation which has shareholders who are not active in the business or familiar with it is in a different situation. This remark applies with especial force to the great corporations that number their shareholders in the thousands or tens of thousands. The great majority of the shareholders of such corporations have only the barest information as to the manner in which the business is handled and as to the results that are being achieved, and are not sufficiently familiar with

the business or sufficiently interested in it to absorb more detailed information if it were given to them. They regard their ownership of a company's stock purely as an investment of capital that will bring them an income. They buy a railroad or an industrial stock with much the same purpose as they would have in buying a real estate mortgage—the only purpose being that of securing a dependable income with a chance at profits. The object that is actually in their minds in making the purchase is not a partnership interest in a going enterprise, but certain pieces of paper called "certificates of stock" which at regular intervals will bring them dividend checks.

To shareholders of this type regularity in their dividend returns is of the highest importance. They count upon these returns as a fixed portion of their income—indeed, in thousands of instances the living expenses of dependents are provided out of these dividends. Approximately half the stockholders of the New Haven Railroad are women. The effort of the directors of a corporation which includes a large proportion of shareholders of this type should clearly be to meet their needs by paying a permanent rate of dividends with the fewest possible fluctuations. This rate of dividends in a really stable and conservatively managed corporation never varies except when it is increased. And it is not increased until after the directors have assured themselves that in all human probability a later decrease will not become necessary. If there are unusual, or possibly temporary, profits which it is thought wise to distribute, the directors of such corporations will ordinarily announce an "extra" dividend or once in a while will cut a "melon" in the form of a stock dividend or a subscription privilege. These extras, however, are to be regarded only as incidents which should not be allowed to disturb the regular and uninterrupted flow of dividends.

The desirability of maintaining regularity of dividend rates rests not merely upon the duty of the corporation to its share-

holders, but also upon a substantial gain for the corporation itself. By reason of the fact that shares which yield regular dividends are in demand by so large a body of owners of capital who are not engaged in active business, there is a much stronger demand for these shares than for those which are paying irregular dividends. Out of two issues of common stock otherwise equivalent, one of which is paying a permanent dividend rate year after year and the other of which is paying dividends irregularly but averaging at least as high as the regular payer, the first-named issue will always sell at a substantially higher price. For this reason, the corporation which has succeeded over a period of years in maintaining a record of dividend stability, and which has not changed and is not likely to change its dividend except to raise it to a permanently higher level, enjoys the benefit of a credit and of a demand for its securities which is worth a large amount of money.

For both these reasons, even the smaller corporations are tending more and more strongly toward so adjusting their affairs that regularity—or at least approximate regularity—of their dividend rates can be attained. It is coming to be more and more widely recognized by bankers, investors, and the public at large, that the ability of a company to maintain regular rates is a better test of its soundness than is its ability to pay high but irregular dividends.

Variability of Profits

In sharp contrast to the desired regularity of dividend payments is the wide fluctuation in profits that is characteristic of the majority of corporations. Business does not move on a regular and even keel. Economic and financial conditions vary; changes in management occur; difficulties with employees arise; changes in taste may suddenly create new markets or wipe out markets—all these and many other factors which are constantly at work bring about kaleidoscopic changes which

often come as great surprises even to people who are intimately acquainted with the business. The sudden outbreak of the European War in 1914, followed by an intense depreciation in iron and steel and machinery industries, was an unexpected variation of this kind. Within a few months it was followed by an unprecedented demand from the European nations at war for the products of American farms and factories, stimulating production and prices to an unheard-of extent; this was a variation no less surprising. It is not necessary, however, to cite the extraordinary conditions produced by the European War.

Rapid fluctuations are constantly taking place even under normal conditions. During the fiscal year 1913, the Lackawanna Steel Company earned over \$3,000,000 available for dividends on its common stock, equal to 8.3; in the fiscal year 1914, prior to the outbreak of the European War, the same company showed a deficit, after payment of fixed charges, amounting to \$1,500,000. The experience of the Mount Vernon-Woodberry Cotton Duck Company after its formation is typical of sudden fluctuations that are apt to occur in any industry. At the time the combination was formed in 1899 there was a large demand for its product. In the first six months of 1900 net manufacturing profits were more than \$750,000; in the second six months of the same year, the profits sank to \$350,000; in the first six months of 1901 there was a manufacturing deficit of \$200,000, to which should be added fixed charges of \$175,000. Certain lines of business, such as building construction, ship construction, iron and steel manufacturing, and manufacturing of novelties and articles of fashion or luxury, are peculiarly subject to great fluctuations. In Andrew Carnegie's famous phrase these industries are either "prince or pauper."

On the other hand, industries which sell small articles for personal use, such as cigars or household sundries, are likely

to avoid fluctuation. The business of the large five-and-ten-cent stores is especially stable; owing to the fact that they are operated on a strictly cash basis, there is usually little difficulty in adjusting expenditures to sales. During August and September of 1914, when almost all other lines of business were suffering, the business of F. W. Woolworth Company and S. S. Kresge Company both showed very satisfactory increases over the business of preceding years.

Companies which follow the policy of protecting their customers and of charging prices that yield them only a moderate rate of profit are likely to be rewarded by being able to maintain a fairly steady volume of sales and of profits. If this policy results in stabilizing dividends, the credit of the company may be so much enhanced as to be of much greater value than any excessive profits it might have extracted from its customers.

Although companies differ widely among themselves, they are all subject to a greater or less degree of *fluctuation* in their profits and at the same time (with the exception of the closely held corporations) they are all under pressure to maintain *regular rates* of dividends. How are these two conditions to be reconciled?

Rule for Maintaining Regularity of Dividend Rate

There is obviously only one satisfactory answer—dividends must not be allowed to rise, even in the most prosperous periods, above a conservative estimate of the minimum earnings of the company. Those concerns which suffer from great fluctuations find this to be a harsh rule. It means that, so long as there remains even a reasonable possibility that earnings may sink close to or below the level of fixed and contingent charges, no dividends whatever should be paid. This has, in fact, been the rule followed by all really successful corporations the nature of the business of which involves un-

avoidable fluctuations. The Carnegie Steel Company ran as a highly successful corporation for many years without paying dividends. When Charles M. Schwab took control of the Bethlehem Steel Corporation in 1902 and started to build it up, it was on the basis of devoting all the earnings to up-building without paying a cent of dividends—and the policy has since been rigorously followed. Even after a corporation of this nature begins to pay dividends, it is not to be expected, if the management is conservative, that they will rise anywhere near the level of the average earnings. The rule of keeping dividend payments below the level of minimum earnings must strictly be adhered to.

Possibly the net result may, at first glance, seem to be a permanent loss to the shareholder, who can never expect on this principle to receive in dividends any large proportion of the actual earnings of their corporation. However, this loss is apparent, not real, for two reasons:

1. The proportion of earnings paid out in dividends being small, there is a rapid increase in the productive capacity of the company, due to betterments provided out of surplus, and this increase may in the course of a few years raise even the minimum net earnings far above the average earnings that would otherwise have been received.

2. The very fact that lines of business in which great fluctuations occur call for extreme patience and self-denial on the part of shareholders, means that comparatively few men are willing to put their capital and energy into getting a business of this nature thoroughly well established and that opportunities for exceptionally large profits are, for this reason, left open.

It is partly owing to this condition that Andrew Carnegie and his partners built up their wonderfully profitable iron and steel business. Their earnings year after year went back into the business, and they did not themselves realize the full

value of the property they had created. But when the time arrived for the formation of the United States Steel Corporation, the market value of the securities that went to the Carnegie Company was well over \$500,000,000. The same rule could be applied with even less question and more rigor to those corporations which conduct a comparatively stable business. For them it is only a minor hardship to keep dividend payments below the level of minimum earnings. This regularity of dividend payments results in a gain in credit that is secured with relatively little sacrifice.

Policies of Important Companies

Taking a few examples first of regularity of dividends, we have such records as that of the American Express Company, which paid regular dividends every year from 1882 to 1901 of 6% ; from 1901 to 1906 of 8% ; from 1906 to 1912 of 12%. The Mergenthaler Linotype Company, during the ten years 1902 to 1912, paid 10% regular dividends plus a 5% extra dividend each year, making 15% annually. The Perra Salt Manufacturing Company has paid 12% annually since 1863.

The dividend record of the John B. Stetson Company, which follows, is an excellent example of stability combined with liberal distribution of large profits accumulated during the earlier years of the company's existence. It will be noted that after 1893 dividends were decreasing slightly, but this is to be explained by reason of the great depression from 1893 to 1896 which could not reasonably have been foreseen:

JOHN B. STETSON CO. (HATS) COMMON DIVIDEND RECORD

1892	6%	1896	4%
1893	6%	1897	5%
1894	4%	1898	8%
1895	4%	1899	12%

1900	15%	1908	25% and 25% extra
1901	17%	1909	25%
1902	17%	1910	25% " 25% "
1903	20%	1911	25%
1904	20%	1912	25% " 25% "
1905	20% and 5% extra	1913	25%
1906	20% " 5% "	1914	25%
1907	20% " 5% "	1915	25%

The Merchants and Miners Transportation Company has been paying dividends at the rate of 20% since 1856.

The dividend record on the common stock of the Proctor and Gamble Company, manufacturers of soap, has been as follows :

1891	8%
1892-1897	12% per annum
1898-1900	20% per annum
1901-1913	12% per annum
1913-1915	16% per annum plus a 4% common stock dividend

The apparent decrease in dividends, beginning in 1901, was due purely to the fact that in December, 1900, the outstanding issue of common stock was doubled by a 100% stock dividend. In reality, therefore, the new dividend of 12% was equivalent to a dividend of 24% on the former issue. In addition to the regular dividend, the company paid an extra dividend of 14.2% in January, 1904, and another extra dividend of 25% in December, 1905.

The Eastman Kodak Company has paid regular 10% dividends since 1902, but with extra dividends in most years running from as low as 9½% to as high as 30%. These extra dividends are so high that they overshadow the regular dividends, and, if any criticism of so successful an enterprise is permissible, it may be based on the desirability of attaining a greater degree of regularity in the extra as well as in the so-called "regular" disbursements.

On the other hand, concerns engaged in fluctuating lines of business, frequently decline to restrict themselves to the payment of a fixed dividend rate. The dividends of the Amalgamated Copper Company from 1899 to 1912, ranged from $1\frac{1}{2}\%$ to $7\frac{1}{2}\%$, and of the Anaconda Copper Company from as low as 3% in 1913 to 26% in 1907. There is less excuse in the case of the American Thread Company, the business of which is relatively stable; nevertheless from 1902 to 1912, dividends varied from as low as 4% to as high as 16%. The Bourne Mills between 1897 and 1912 paid dividends which fluctuated from as low as 3% to as high as $49\frac{1}{2}\%$.

Following is the record of the Porto Rican American Tobacco Company, which is even more remarkable for the extent and rapidity of its fluctuations:

1904	8 %
1905	$31\frac{1}{2}\%$
1906	84 %
1907	$10\frac{1}{2}\%$
1908	5 %
1909	9 %
1910	14 %
1911	16 %
1912	16 % plus 20% (scrip)
1913	20 % (scrip)
1914	20 % (scrip)
1915	8 % plus 5% (scrip)

The Atlantic Refining Company, like various companies of the oil and other extractive industries, prefers to allow its dividends to fluctuate with its profits. Before the disintegration of the Standard Oil Company it was customary for the directors to make up their minds at the end of each quarter what rate of dividend for the quarter should be declared. In this case the fact that the company, although of enormous extent, was comparatively closely held, was no doubt another reason for following the practice.

From companies engaged in extractive industries come the most remarkable records of enormous profits, and it is perhaps natural that the desirability of stability in their dividend disbursements should not appeal to them as of great importance. The Calumet & Hecla Mining Company, which has outstanding about \$2,500,000 of capital stock with a par value of \$25, of which only \$12 per share is paid up, has paid out total dividends from 1871 to 1913 amounting to over \$121,000,000. One of the largest dividend-payers was the Koloniale Bergbau Gesellschaft (Colonial Mining Company), a German concern, which operated diamond mines in German Southwest Africa. Its capital is only about \$25,000. Its dividend record before the war was:

1910	2,400%
1911	2,500%
1912	3,800%
1913	2,500%

Total for four years.....11,200%

That many manufacturing companies have not yet reached the ideal condition above described of paying regular rates of dividend which are never changed except to be increased, is shown by the record for the 18 months—January 1, 1913 to July 1, 1914—of industrial corporations the stock of which is listed on American stock exchanges. Forty-three of these companies passed their dividends; sixteen others reduced their dividends. This took place in a period of depression, to be sure, but not in a period of sudden or overwhelming crisis.

The great advantage of prudent management in the maintenance of a low but regular rate of dividends is shown in the record during recent years of two great railroad companies. In 1913 the earnings of the Pennsylvania Railroad Company fell to the lowest figures except one in fifteen years, and in 1914 there was a further sharp decline. Nevertheless, even at

this level the company's regular 6% dividends were not for a moment endangered. In 1914 and 1915 the Canadian Pacific Railroad Company passed through a tremendous crisis brought on by the European War. It had been the practice of this company to pay a regular dividend of 7% out of operating earnings and an additional dividend of 3% derived from the company's holdings of securities in subsidiary enterprises. Although during the year of crisis, the 7% was not fully earned, income from other sources was sufficient to enable the company to go ahead with its regular 10% rate.

Paying Dividends from Accumulated Surplus

Frequently the question arises whether dividends which have not been earned during a given period should nevertheless be paid and charged against the surplus that has been accumulated in previous periods. Ordinarily the answer that should immediately be given is, no. In ordinary practice surplus, as will be more clearly emphasized in the chapter following, is as much a part of the permanent capital of a company as is the capital stock itself. It is not invested in such a form as to make it available for the payment of dividends and it is understood as a matter of course by the creditors of the company that it represents a permanent investment.

All this refers to customary financial practice, and not to the legal view of surplus which makes no distinction between that which has been accumulated in the past and that which is current. The legality of paying dividends out of accumulated surplus, which has seldom been seriously questioned, was reaffirmed in the New York courts in 1914 in an action brought by the preferred shareholders of the Union Pacific Railroad Company to enjoin the distribution of certain shares of stock and amounts of cash held in the treasury of the company to the common shareholders. The Union Pacific, which had been paying 10% per annum, desired to distribute securi-

ties and cash which would yield 2%, and thereupon to reduce its regular dividend payment to 8%. Certain preferred shareholders objected on the ground that this extra distribution would be charged, not against current surplus, but against accumulated surplus, and that the preferred shareholders had acquired a vested right, as a part of their equitable interest in the company, to be protected by the full amount of the accumulated surplus. No legal grounds for granting the injunction asked for were found by the court and the action was dismissed. Granting, then, that accumulated surplus is legally available for the payment of dividends and that customary practice makes it unavailable, the question still remains whether exceptions to this customary practice should ever be admitted. In July, 1914, the directors of the Baltimore and Ohio Railroad Company voted the usual semiannual dividend of 2% on the preferred and 3% on the common. The required total of dividends for the year, which amounted to \$11,538,888, was greater than the surplus during the year by \$2,469,095. It was explained unofficially that the company had not exercised its privilege of prorating depreciation charges over a series of years, but had charged against current earnings over \$2,000,000 of losses incurred in the Central Western floods of March, 1913. The action of the directors was based on the belief that the decline in earnings was only temporary, and on a profound desire to maintain an unblemished record of regular dividends. There is no question as to the conservatism and ability of the board and this action was somewhat grudgingly accepted by the financial community as sound and correct. Nevertheless, it is by no means to be regarded as a precedent, but only as an isolated concession.

Cash Requirements for Dividends

In discussing the payment of dividends so far in this chapter, our attention has been concentrated, as is usually the

case, on the relation between dividends and profits. It has been assumed that adequate and regular profits—provided they are correctly estimated—justify dividends. But this assumption must not be permitted to stand longer unchallenged. It is, in fact, the direct source of a large proportion of financial embarrassments. Thousands of corporations which have been able to report highly satisfactory profits and which have paid good dividends on the strength of those profits, have found themselves a short time later—to the intense surprise and indignation of their stockholders and even of their directors and officers—in the hands of their creditors. It is quite apparent that many business men, even including some of unusual capabilities, do not fully grasp the fact that dividend payments should be dependent not only upon profits, but also upon the corporation's cash position.

The point has already been emphasized and will later be reiterated, that many companies find their chief financial difficulties arising not in periods of depression and small business, but in their periods of prosperity. To attempt to do a large volume of business with a small working capital is one of the quickest and surest methods of financial hari-kari. Yet this is precisely the course that is followed by those concerns which, on the strength of a showing of profits, declare dividends, the payment of which seriously depletes their working capital. Under these conditions the only prudent course is to withhold dividends until in the normal course of the company's business cash is accumulated beyond the requirements of the business. It is not merely a book surplus, but in addition a satisfactory cash balance, that should furnish the basis for a declaration of cash dividends.

To give a concrete illustration of a situation which does not justify cash dividends, we may take the case of a flour mill company operating in Canada which has outstanding capital stock of \$1,000,000. During a recent year the com-

pany reported net profits available for dividends amounting to \$91,462, and declared dividends of \$30,000, or 3%, leaving an addition to the surplus of \$61,462. On the face of it there would seem to be no reasonable question as to the conservatism of this small dividend declaration. When we come to examine the company's balance sheet after payment of the dividend, however, we find that it shows a secured overdraft at its bank of \$191,000. Its cash on hand is less than \$6,000, and its cash and receivables together are less than its current liabilities. A glance at this balance sheet is enough to prove that the payment of dividends was not merely unwise, but a thoroughly reckless and dangerous proceeding.

Another example, which indicates clearly the results to stockholders of carelessness in figuring on cash requirements for dividends, is furnished by the history of the New England Cotton Yarn Company which was in existence from 1899 to 1903. During these four years the company was earning sufficient profits out of which to pay preferred stock dividends and actually paid these dividends, amounting in the aggregate to \$1,212,500. During the four years cash fell approximately, from \$2,000,000 to \$500,000; notes payable which had been at one time reduced to as low as \$650,000, rose before end of the four years to over \$2,000,000. The inevitable result was receivership. Without the heavy outgo of cash dividends this might have been avoided. Even the preferred stockholders who received the dividends were heavy losers by this policy; although they received \$24.25 a share in dividends, the market value of their stock went down from \$105 to \$25.*

Paying Dividends with Borrowed Cash

Sometimes circumstances arise which justify the directors of a corporation, in their opinion, in borrowing the money with which to pay dividends. This is, in fact, quite frequently

*Dewing's "Corporate Promotions and Reorganizations," p. 324.

the case with companies which have to contend with wide seasonal fluctuations and with companies which normally operate with a small working capital. As has previously been pointed out, transportation and communication enterprises frequently belong in this last-named group. Commenting on numerous cuts in the dividends of railway corporations, the *London Financial Times* of October 2, 1914, says editorially:

It is necessary to be guided by the amount of cash actually in the till. Borrowing on temporary loans from one's bankers in order to make up the heavy amount of ready cash required to pay dividends—a common and perfectly proper procedure in normal times—is much less desirable under existing financial conditions.

For companies of the two types just referred to, it may be sound policy at times to pay dividends with the proceeds of temporary bank loans—assuming, of course, that there can be no reasonable question as to the company's ability to repay these loans without crippling itself. There is a great distinction, however, between this situation and that which exists when a corporation issues long-term obligations or when it sells additional stock in order to obtain money with which to pay dividends. If a corporation were to follow this practice during a period when it was not actually making a legitimate showing of profits, it would be clearly engaged in a fraudulent transaction. When it issues long-term obligations or sells additional stock during a period of adequate profits or for the purpose of paying dividends that are charged against accumulated surplus, its course of action is not necessarily fraudulent, but it is certainly open to serious question as to its essential soundness.

A case which aroused a great deal of discussion in financial circles occurred in 1913, when the management of the American Can Company decided that the time had arrived when it was advisable to pay up a portion of the dividend claims

on its preferred stock issue which had been accumulating over a period of several years. The company sold an issue of \$14,000,000 5% debenture bonds and with the cash proceeds paid a 24% dividend on preferred stock. The consensus of opinion among conservative judges, it may safely be said, was that it would have been far wiser to have paid off the arrears of preferred dividends gradually out of profits as they accumulated. Although it is true that this plan would have involved deferring common dividends for a period of years, it would have put the company eventually into a position of undoubted financial strength.

Effects of Lack of Prudence in Paying Dividends

It seems almost superfluous, after what has been said above, to cite examples of financial difficulties which are traceable to the payment of dividends which were not earned or which could not be met without reducing working capital below the limits of safety. The number of examples is practically infinite. Some of the most flagrant are furnished by the records of important industrial combinations. Following is a self-explanatory extract from a review published in the *London Statist* of October 17, 1914:

The evil result of continually paying out the earnings of a company—and perhaps a little more—may be illustrated from the experience of Dick, Kerr and Co. The annual net trading profits of this company for a series of years has been as follows:

1909	£28,168
1910	22,821
1911	37,994
1912	3,275
1913	30,092
1914	44,762

On the whole, the net profits show a favorable tendency toward increase, although this is strikingly inter-

rupted by the bad year, 1912. In 1909-10-11, the company paid in addition to its full debenture interest, preference dividends amounting to £18,300 and ordinary dividends amounting to £13,000, leaving annual deficits as follows:

1909	£18,425
1910	20,884
1911	5,366

In 1912, the ordinary dividends were cut off and have not since been resumed, but the preference dividends were continued with the result that in that year a deficit was still shown of £26,876. In the following year there was a surplus of £309, and in 1914, a surplus of £15,201. On October 15, 1914, the preference shareholders gave their consent to the issue of additional debenture stock. It was stated that the company's cash resources have been greatly depleted by the redemption of existing debentures and at the same time the need for working capital has increased. "For some time past, temporary accommodation has been obtained from the company's bankers or others."

As to the record of American industrial combinations, we cannot do better than present the following abstract from the conclusions ably stated in Dewing's "Corporate Promotions and Reorganizations."

Nearly all the large industrial combinations have been guilty of distributing dividends recklessly. This is due in part to the extravagant promises on the strength of which securities have been sold, in part to the optimism of promoters and directors, in part to a desire to unload on the part of many of the insiders.

The failures of the Corn Products Co., The American Malting Company, the U. S. Realty Co. and the New England Cotton Yarns Co. were the direct results of unwarranted payments of dividends. The U. S. Leather Co., the National Cordage Co., the National Salt Co., the Consolidated Cotton Duck Co., and the International Cot-

ton Mills Corporation, were all seriously weakened by payment of dividends at the expense of their cash position.

In the case of the American Malting Co., it was proved that the directors must have declared dividends without having before them any statements of earnings. This same thing probably is true also of other corporations.

The great fluctuations in industrial earnings are the chief argument against the use of bonds by industrials and in favor of conservatism in paying dividends. In 1908 the Westinghouse Co. had gross sales of \$20,000,000 and a deficit of \$1,000,000. In 1909, gross sales of \$30,000,000 and net profit of \$3,000,000.

These fluctuations involve a strong tendency to borrow on short-term notes or even to use short-term notes as a means of raising money with which to pay dividends.

There is sound reason for borrowing on short time in order to meet fixed charges inasmuch as the insolvency and reorganization of the company, even though it be only temporary, involves a severe blow to its credit and trade. For instance, after the panic of 1907, the General Electric Co. had a loss of 25% in its business and the Westinghouse Co. 37%. The explanation seems to be in the failure of the Westinghouse Co.

The fact that insufficient working capital exists at the time of the insolvency of a company is not proof that this is the actual cause of insolvency. It is very often true that the lack of working capital is itself due to unwise payments on account of fixed charges and on account of dividends.

The only possible reasons which can lead directors to pay out unearned dividends are:

1. Ignorance.
2. A false belief in the immediate return of prosperity.
3. A desire to give the corporation a higher standing in the stock market, or with creditors, than its earnings warrant.

Scrip Dividends

Scrip dividends are those which are issued in the form of promises to pay on the part of the corporation. These promises may or may not bear interest. They usually mature at some definite date, but may be purely indefinite I. O. U.'s, redeemable at the option of the corporation or redeemable within a certain limit of time. They are intended usually to meet the situation which has been briefly described above—that of a corporation which has made a good showing of profits during a given period, but is not in sufficiently strong financial position to part with cash. Payment of dividends in scrip is sometimes voted in order to avoid spoiling a dividend record that would otherwise be unbroken or as a temporary expedient to keep up dividends on preferred stock. After the first Westinghouse reorganization in 1891, the first dividend of $1\frac{3}{4}\%$ on the preferred stock was issued in scrip, so as not to reduce the working capital immediately. In October, 1914, the Cambria Steel Company desired to keep up its regular 5% dividends, but, on account of the European War, the directors did not think it wise to pay out in cash the \$562,500 required. On account of the dull state of trade, inventories were larger than usual, and available cash resources were smaller than usual. The directors solved the difficulty by issuing a scrip dividend bearing 5% interest. In 1910 the Crucible Steel Company of America took care of a portion of the accumulated dividends on its preferred shares by paying 10% on these shares in the form of scrip bearing 3% interest.

In 1881 Henry Villard after a considerable struggle obtained control of the Northern Pacific Railroad. In the course of his fight for control he had advocated the payment of dividends on the company's preferred stock, and in the first annual report after his election as president it was stated that the surplus earnings since 1875, amounting to \$4,667,490, had been used for construction and were properly due to the pre-

ferred stockholders. On the strength of his statement, the directors declared a dividend to the preferred stockholders of 11%, which was not paid in cash but in the form of 5-year 6% obligations of the company redeemable after one year at the option of the company. When this scrip fell due in 1887, the company was in no condition to pay it in cash. It therefore imposed on its property a third mortgage amounting to \$12,000,000, over \$3,000,000 of which was used to meet the maturing dividend scrip.*

The payment of accumulated dividends on preferred shares has been, in a number of cases, taken care of in this manner. The Trenton Potteries Company has outstanding \$411,570 of "funding certificates" which were issued to stockholders who exchanged their 8% cumulative preferred for a new issue of 8% non-cumulative preferred. These stockholders received 44%, being the amount of their dividends in arrears, in the form of "funding certificates."

Stock Dividends

A form of dividend payment which appears to be growing in popularity is the issuance of stock representing profits not otherwise distributed. Stock dividends are issued for any of three reasons :

1. In order to give to stockholders tangible evidence of the increasing value of their property.
2. In order to maintain the market value of the stock at a price which will make it more readily marketable.
3. In order to veil huge profits in prospect by making it possible to declare a small or moderate dividend on a large amount of stock instead of a very high dividend on a small amount of stock.

*Daggett's "Railroad Reorganizations," pp. 274-276.

These three motives are not always clearly distinguished; one of the three is usually predominant. It will be agreed by everyone that the payment of a stock dividend does not in itself add anything to the assets of the stockholders who receive the dividend. If the owner of one share of stock in a corporation with \$100,000 stock outstanding, is given, we will say, a 900% stock dividend, so that he becomes the owner of 10 shares in a \$1,000,000 corporation, his real standing has not been changed in the slightest. He remains, just as he was at the beginning, the owner of $1/1,000$ interest in the enterprise. His only real gain comes in the mental satisfaction that he receives if he continues to hold his stock indefinitely (and this is by no means a negligible factor), or in the easier marketability of his holdings if he wishes to sell them. Even the third motive does not affect the shareholder's income but merely the nominal rate of dividend on his holdings.

A clear illustration of the predominance of the first motive is to be found in the recent announcement of a 10% stock dividend on the part of the Corporation of Riker and Hege-man, a company which owns a chain of drug stores which is controlled by interests associated with the United Cigar Stores Company. During the process of building up this last-named company, no cash dividends were declared but the increasing surplus was represented by frequent declarations of stock dividends. A number of other companies have adopted the practice of paying regular stock dividends in addition to cash bonuses. The annual 4% stock dividends of the Proctor and Gamble Company have been referred to. The American Light and Traction Company has for several years declared regular quarterly dividends of $2\frac{1}{2}\%$ in cash and $2\frac{1}{2}\%$ in stock. The United Light and Railways Company is paying quarterly dividends of 1% in common stock. The American Gas and Electric Company and the City Service Company have also paid small stock dividends. It may be assumed that the

practice in the case of public utility companies has in view the desirability of keeping down the rate of cash dividends to a moderate amount. Much the same plan has been followed by some of the English public utility companies.

Stock dividends which are intended to represent large accumulations of surplus that could not be disbursed in cash have been especially frequent of late years among automobile companies. The Packard Motor Company is said to have paid no cash dividends on its common stock, which is closely held, but did pay in 1913 a 40% stock dividend on its \$5,000,000 common previously outstanding, bringing that issue up to \$7,000,000. The General Motors Company not long ago declared 150% stock dividend. The record among motor companies up to the present time is held by the Chalmers Company, which in 1910 paid a stock dividend of 900%. Even this record, however, is likely to be overshadowed by the action on the part of the Ford Motor Company, which has been announced but not yet put into effect, providing for a stock dividend of 2,400% with a view to raising its outstanding capital stock from \$2,000,000 to \$50,000,000.

The record of the Singer Sewing Machine Company, with its various stock dividends of 100 and 200%, has been previously mentioned. Other instances are those of the Pabst Brewing Company, which paid out an issue of \$2,000,000 7% cumulative preferred in the form of a 20% stock dividend to its common stockholders; the Pacific Mills, which increased its capital stock from \$3,000,000 to \$12,000,000 by the declaration of a 300% stock dividend, at the same time reducing the par value of its shares from \$1,000 to \$100; the American Rolling Mills Company, which paid a stock dividend of 33 1/3% in 1907 and another stock dividend of 100% in 1909; the Adams Express Company which in 1907 paid a special dividend in the form of 4% collateral trust bonds; the George E. Keith Company, which in 1913 issued \$4,000,000 7% cumu-

lative preferred as a 200% stock dividend; and the Midvale Steel Company which in 1910 declared a 1,200% stock dividend increasing the outstanding issue from \$750,000 to \$9,750,000.

It should be remarked at this point that the issuance of preferred stock or of bonds in payment of dividends is a device that may be regarded as in one sense actually increasing the property interests of each stockholder. Yet, after all, each shareholder is lifting himself by his own boot-straps; whatever he gains in the form of a prior claim for interest or preferred dividends, he has gained at the expense of his common shareholdings which are thereby reduced to a correspondingly lower level. Even in these instances, therefore, the statement that a stock dividend does not in itself change the real value of a stock owner's holdings is substantially correct. The effect of an increase in stock which tends to reduce the market value of each share and thereby to make it more readily marketable, has been discussed in earlier chapters. It is sufficient here to give one illustration.

In 1892 the National Cordage Company, which had been organized in 1887, was at the height of its prosperity and its stock was one of the leading securities on the New York Stock Exchange. In the autumn of that year, a member of the Exchange remarked to President Waterbury, "Your stock is selling too high," meaning that for speculative purposes it would be better to have the stock selling at \$70 a share rather than at \$140. President Waterbury presented the idea to the board of directors who decided to issue in January, 1893, a 100% stock dividend. The book value of the subsidiary plants was marked up to correspond with the inflation of the capital stock. Through the payment of the dividend the outstanding stock was increased from \$10,000,000 to \$20,000,000. The directors explained that the new issue was "to represent about \$10,000,000 of assets acquired by the company since its forma-

tion, and which it is the policy of the company to hold intact." The directors also stated that it would be the company's policy to pay dividends of 7% on the new common stock. A little over a year later the company was in the hands of receivers.*

Legal Rules Affecting Dividends

It would be inadvisable to close this chapter without calling attention to some well-established legal principles which should always be kept in view. Perhaps the most important of these principles is that dividends shall be paid only out of surplus and never out of capital. The Corporation Act of New Jersey provides that directors who take part in such action, or who do not enter a protest within a reasonable period, shall be personally liable during a period of six years following the payment of such dividends. The best-known case which has established and emphasized this principle is that of the American Malting Company. During the first year of the existence of this company the directors declared cash dividends, apparently on the strength of "anticipated" profits which were included in the income account. After the facts became known, suits were brought by stockholders both in New York and New Jersey, and in both states the suits were decided in favor of the stockholders. After litigation lasting almost five years, the matter was settled by the payment on the part of individual directors of \$500,000, \$340,000 of which went into the treasury of the company and \$160,000 to the plaintiffs for the expenses of their suits.

Another important legal principle is that dividends once declared become an indebtedness of the corporation to the stockholders and cannot afterward be rescinded by the directors. It is even held in most jurisdictions that dividends once declared no longer belong to the corporation but have become the property of the stockholders as individuals.

*Dewing's "Corporate Promotions and Reorganizations, p. 132.

There are numerous special requirements and limitations contained in the constitutions of the various states. As an example, attention may be called to a law in the State of Massachusetts forbidding the issuance of stock and scrip dividends by public utility companies, which reads as follows:

No company shall declare any stock or scrip dividend or divide the proceeds of any sale of stock or scrip among its stockholders; nor shall any company create any additional new stock or issue certificates thereof to any person unless the par value of the share so issued is first paid in cash into its treasury.

CHAPTER XX

SURPLUS

Surplus Reserve and Surplus Fund

The final item in our formula for income consists of "balance carried to the permanent surplus account." It is sometimes labeled "surplus for the period," but, inasmuch as this phrase is applied also to what we have called "balance applicable to dividends and surplus," it is somewhat misleading and for this reason is not used. Much confusion of thought arises out of the continual inaccuracies and variations in the application of such terms as "income," "profits," "earnings," and "surplus." Until the general usage of this and many other business terms becomes more clearly settled, it will be impossible wholly to avoid this confusion.

Two terms which should be clearly distinguished, however, are "surplus reserve" and "surplus fund." Surplus reserve, more frequently referred to simply as "surplus," is in effect simply an account or a group of accounts kept in the company's books which show the value of the equity belonging to stockholders over and above the par value of the outstanding shares. Like many other accounts, surplus is in part the result of estimate or of a series of estimates. If the estimate is judged by the directors or officers of the corporation to be wrong, it may be changed by a mere entry in the company's journal. An instance has been cited in the preceding chapter of the marking up of the book value of the plants and other assets of the National Cordage Company by \$10,000,000, in order to create on the credit side of the balance sheet an increase in the surplus account of \$10,000,000 from which a stock dividend could be paid. An instance has previously been given also of

a publishing company, the good-will account of which was increased by \$300,000 in order to inflate the surplus account by a like amount. In the section following, the various methods through which a surplus account may be built up are reviewed. For the immediate purpose, it is sufficient to emphasize the point that surplus reserve is in itself purely a more or less formal and inconclusive appraisal of the shareholders' equitable interest in the corporation above the par value of their holdings.

A surplus fund, on the other hand, is an asset account which can be properly used only to designate certain sums of cash, of securities, or of other property, which are set aside, not for use within the business, but for some supplementary purpose such as the retirement of certain securities or for the general protection and insurance of the shareholders against loss. The surplus fund seldom exists in this country under this title. It not infrequently happens, however, that a company carries holdings of cash or securities not needed in its business and set aside for a special purpose which could properly be labeled "surplus fund," if it were so desired. Surplus reserve and surplus fund, even where they coexist, are by no means necessarily equivalent.

In this volume, and in customary usage, the word "surplus" when used alone without qualification, refers to surplus reserve. The fact that it refers to a credit account—for which the corporation is responsible to its shareholders—and not to an asset or to any group of assets, should be borne clearly in mind.

Five Sources of Surplus

We have spoken of surplus in the preceding chapter as if it were always derived from earnings. Ordinarily this is so but surplus may result from other causes as well. Five possible sources of surplus are given below:

1. Inheritance from previously absorbed corporations.
2. Sale of securities above par.
3. Sale of assets above their book value.
4. Revaluation of assets.
5. Accumulation out of earnings.

The first source is uncommon, inasmuch as most new corporations, even those which take over going businesses, carry the assets which they acquire at their full cost value—no more and no less—so that they start with neither a surplus nor a deficit; and this would seem ordinarily to be the correct procedure. However, there are occasional exceptions. In 1914 the Dominion Linens Company of Canada was organized with an issued capital stock of \$250,000. The company, according to a statement prepared by the well-known accounting firm of Price, Waterhouse and Company, showed assets of \$267,-684. After deducting a small amount of accounts payable there was left a surplus at the outset of \$14,138. It should be remarked, however, that among the assets was one item of "good-will, trade-marks, etc.," valued at \$20,000. A surplus of this nature can hardly escape the suspicion of being more or less fictitious. It is scarcely safe to assume that the assets acquired are worth more than what was paid for them. The fact that these assets may have been carried on the books of the previously existing companies at a higher book value than was paid for them, has no bearing on the case so far as the new company is concerned.

The second source consists of the sale of securities above par. In such a case the corporation receives a greater sum than the nominal value of the obligations or the shares which it issues. This additional sum may be carried to an account called "Premium on Securities" or some such title, or it may be and frequently is credited direct to surplus. It is clear that a surplus which arises in this form is hardly to be regarded

as a proper source of dividends, inasmuch as the premium on shares or bonds is in reality a contribution to the capital assets of the company. In handling transactions of this type, industrial and railroad corporations might profitably take a leaf from the practice of banks. In organizing new banks it is frequently agreed that every \$100 share shall be sold at \$125 or \$150, or some other amount above its nominal value, so as to create a surplus account at the outset. As the bank earns profits, these are carried, not to the Surplus account, but to an account entitled "Undivided Profits" out of which dividends are declared. From time to time the directors may, more or less arbitrarily, transfer whatever sums they decide upon from the Undivided Profits account to the Surplus account. It is understood that credits to surplus are not intended to be distributed, but are regarded as an integral part of the permanent capital of the institution.

The third source is through the sale of permanent assets, which are not intended for trading purposes, for a sum above their book value. Frequently assets are written down over a long period until their book valuation becomes only a small portion of their real value. To take an extreme and notable instance, the immensely valuable property of the Bank of England on Threadneedle Street, London, does not appear on the balance sheet of the corporation at all.

The fourth source of surplus is the revaluation of assets which have not been sold but are intended to be retained. This is a tempting expedient for a company which is running at an operating loss or with very small profits, and yet is under pressure to make a satisfactory showing. In the latter part of 1902, the management of the United States Leather Company decided to reappraise certain large areas of hemlock bark land which had been bought at a fair market valuation in 1893. Since then prices of timber and of bark had gone up. A committee of directors reported in 1903 that the bark

property was worth about \$14,000,000 more than its book value. In order to show this increased value on the books, the officials incorporated the Central Pennsylvania Lumber Company (all of the stock of which was owned by the United States Leather Company); the lumber company bought the timber (only) on the revalued bark land, for which it gave \$10,000,000 of first mortgage bonds. It was intended to pay dividends on the preferred stock out of this suddenly acquired surplus. However, the original contract between the corporation and its preferred shareholders stated that dividends should be paid only out of net earnings, and the revaluation of the timber lands could hardly be construed as "net earnings." On the other hand, it was argued that the timber had actually been sold and securities had been received in payment. In the end, the question was settled without bringing before the court the dispute as to whether the formation of the subsidiary company and the transfer of its bonds was or was not merely a fiction.

The handling of timber properties so as to present a fair statement of the results that are actually achieved, always raises difficult questions. Taxes assessed against timber lands are frequently charged into an asset account in order to show the total carrying charges of the property. The continual rise in land values, and especially in the values of timber properties, has been so regular that this method has seldom been found disappointing. As to the revaluation of timber properties, it is thought by some authorities that there is no special objection in this case, provided the surplus thus created is put into a separate account and not treated as a part of the general surplus available for dividends.

The question as to whether assets should be revalued or not frequently arises, also, in the cases of banks and other financial institutions which own large amounts of securities. On a rising market these securities may frequently have a

market value much higher than their original cost, and the officers or directors of the company may desire that this extra value should be shown on the books and credited to surplus. Independent accountants are usually strongly averse to this practice, on the ground that it makes a fictitious showing of profits. If the securities are actually sold and a profit is realized, then this profit will naturally go into a surplus account. Otherwise it is regarded as sound and correct to carry them at their cost valuation. It is not, however, inconsistent with this principle to insist that declinations in market value should be written off against surplus.

It must be remembered that the surplus account is at best only an estimate and that it is highly desirable to keep this estimate always well within conservative limits. In operating an enterprise and selling its products, a valuable trait is the optimism that will carry a man forward through discouragements and temporary defeats. But in estimating the results and forecasting the future, it is necessary above all to be cautious and even skeptical.

In general it is safe to say that the instances in which an upward revaluation of the permanent assets of a company is permissible, are highly exceptional and that in these exceptional cases the surplus thus created should always be plainly earmarked so that there will be no mistaking its source.

The fifth and most important source of surplus consists of savings out of the company's earnings. We have already seen that every year should yield a balance of profits above all fixed charges and above all dividends. This balance, if credited to surplus year after year, will in time build up a large surplus account. If the building up of this account is accompanied by consistent writing down of all assets of doubtful value, the balance sheet of the company will in time show an increasing equity on the part of the shareholders of a very substantial nature. If surplus were always built up only out of con-

servatively estimated earnings, it could be safely accepted as a fairly accurate measure of the real prosperity and solidity of the business. But surplus which comes from the other sources that have been named—even though it may be a genuine surplus which has been realized—gives no convincing evidence of earning power or of conservative and level-headed management.

The term “surplus,” therefore, in itself means little. It should always be examined with care and its origin should be determined before basing upon it any judgment as to the prosperity or good management of the company which shows it.

We have now to consider what principles should be followed in accumulating surplus out of earnings and what uses should be made of the increased assets which are represented in the surplus account.

Accumulating Surplus

In discussing the desirability of establishing and maintaining a regular rate of dividends it has been suggested that the only safe principle to follow is to fix the dividend rate below the estimated minimum earnings, thus making sure that it will be kept up year after year. This leaves all the extra profits of good years to go into surplus. If the company's business is of a highly stable nature so that the fluctuations in earnings are slight, it follows that the extra earnings of the good years will be relatively small and surplus will accumulate slowly. If the business, on the other hand, fluctuates a great deal, these dividends will absorb only a small proportion of average earnings, and the greater portion will remain as a credit to the surplus account.

This principle, therefore, automatically results in piling up a surplus almost in direct proportion to the degree of fluctuation of earnings. And this is as it should be. A company engaged in a business which enjoys steady earnings will have

no trouble in raising fresh capital for any extensions that may be required and which can be shown to be clearly profitable. It is not necessary, therefore, that new capital should be provided by savings out of earnings. On the other hand, a company, the earnings of which fluctuate widely, is, on the face of it, engaged in a speculative business and cannot easily secure fresh capital on favorable terms. Only through accumulations out of earnings can the business be extended and stabilized.

The principle that has just been stated is, of course, put forward only as a general rule which is subject to innumerable qualifications and exceptions. First of all, it may be impossible to determine in advance what the minimum earnings are likely to be. Second, it may be desirable to use some discretion and diplomacy in dealing with stockholders and to satisfy their wishes from time to time by distributing a portion of the extra earnings of prosperous years. For both these reasons the strict and inflexible application of the rule that has been stated is not always to be insisted upon. Most well-managed companies are satisfied if they reach some reasonable approximation in applying the rule.

There is another qualification, also, of still greater importance. In all that has been said as to this rule, it has been taken for granted that fresh capital can be taken into any business enterprise and used as profitably as the original capital. In a great many cases this is true, especially if the fresh capital is not dumped upon the company in one or two big lots secured through the sale of securities, but is gradually added year after year and thus made available for betterments and extensions that are actually needed. However, even in those cases there may, after a time, come a limit to the development of the company beyond which fresh capital cannot be profitably applied. When this limit is reached, it is no longer desirable to accumulate surplus with rapidity. If earnings have not at that time been stabilized, it may be good policy

to pay out most of the income year after year in dividends, allowing the dividends to fluctuate in close relation to the income. Or it may be adjudged better to fix the dividend rate at about the average anticipated income, in which case extra profits of the good years will be invested outside the company in short-term securities which will be sold when necessary in order to provide cash or dividends during the lean years. It is perhaps due to the fact that opportunities for expansion of most successful enterprises in the United States are almost unlimited, that so much emphasis has been laid in our financial practice on the necessity of making large savings out of annual profits; whereas in European countries, where the opportunities for expansion are more limited, the custom prevails of paying out most of the annual earnings in dividends and of relying upon fresh issues of securities to provide whatever new capital is needed.

Policies of Various Companies

In connection with the preceding section, the Hendee Manufacturing Company may be cited as a typical example of American practice; this is a relatively small but prosperous, rapidly growing, and evidently well-managed corporation, which specializes in the production of motor-cycles. In the year ended August 31, 1914, this company earned profits of \$711,566, out of which it paid dividends of only \$131,250; a sinking fund of \$150,000 for the retirement of preferred stock was also deducted, leaving the amount of profits for the year carried into the surplus account, \$430,316.

By way of contrast we may take at random a well-known and well-managed English company—Harrison and Crossfield, Limited—which has been earning profits of about the same amount as the Hendee Company. During the four years 1910-1914 net profits averaged about £150,000, from which have been normally deducted:

Dividends on 5½% cumulative preferred shares.	£27,500
Dividends on the 10% preferred ordinary shares.	£30,000
Dividends on management shares....	£30,000 to £67,500
Approximate remaining balance	£60,000 to £25,000

However, this balance is reckoned before providing reserves for depreciation and other charges and after they have been taken out there is ordinarily remaining only a small accumulation of surplus. This is cited, not as an unusual, but as a typical, case of English practice.

Sometimes the American policy is carried to an extent which creates a remarkable disproportion between the capital account and the surplus account. The Storey and Clark Piano Company, for example, which owns fifteen retail stores, is reported to have outstanding capital of \$100,000 and a surplus of over \$2,000,000. The Ford Motor Company at the end of the fiscal year 1914, had capital stock of \$2,000,000 and a surplus of nearly \$49,000,000. However, these unusual relations are to be ascribed, not so much to an unusual amount of savings out of income, on the part of these two corporations, as to their omission to follow the usual practice of revising their capitalization from time to time to conform to the increasing assets and earnings. Most prosperous American industrials save the greater part of their earnings, but through stock dividends and other processes of "watering," their prosperity appears in the form of enlarged capital accounts rather than enlarged surplus accounts.

The Pennsylvania Railroad Company, in applying the principle that has been stated in the preceding section, has endeavored for some years to put a dollar into the surplus account for every dollar that has been paid in dividends. In other words, it aims to divide its balance of earnings, after providing for fixed charges, about evenly between dividends and surplus. During the eleven years ended June, 1913, the company maintained dividends at 6% with an occasional extra

dividend of 1%. During these same years the additions to surplus as compared with capital stock were as follows:

1903	8.45%	1909	5.79%
1904	4.42%	1910	6.64%
1905	5.71%	1911	4.47%
1906	7.92%	1912	4.24%
1907	6.76%	1913	3.97%
1908	5.91%		

In spite of the Pennsylvania's accumulating surplus and highly conservative policy the price of the stock has been in recent years seeking a lower level. This is probably due in part to general economic conditions, but in part also to the apparent belief on the part of investors that the surplus of the company, great as it is, is no more than is required to secure the maintenance of the present rate of dividends.

Railroad companies under English influence, no matter where they may be located, seldom accumulate any considerable amount of surplus. For instance, the Buenos Ayres Great Southern Railway, in 1913, out of a total available surplus for the year of £3,157,500, after paying interest and dividends, carried forward only £473,600. The next year, out of £2,891,200 the company carried forward only £316,100. In 1913 the Buenos Ayres Great Western, out of net revenue of £1,246,500, carried forward £125,100. In 1914, out of £1,041,400, they carried forward only £47,100. The Central Uruguay Railroad, out of available surplus of £384,500, in 1913, carried forward £29,900; in 1914, out of \$329,900 it carried forward £54,100. In all these cases, the railroads were paying fair to good rates of dividends on their ordinary shares.

"Rainy-Day Funds"

Some companies make it a practice to invest a portion of their saved earnings, in securities or readily salable prop-

erty held outside the business, as an insurance that dividends will be maintained. This practice is much more common abroad than in this country, although not wholly unknown here. At the end of the fiscal year 1914, the directors of George Newnes, Limited, an English publishing house, proposed to carry £25,000 out of the profits of the year to a "Dividend Equalization Account" which would then amount to £50,000. It is to be presumed, though it is not so stated, that this "Dividend Equalization Account" would be represented on the asset side of the balance sheet by a surplus fund consisting of cash or securities set aside and available for quick sale in case of need. Unless there are assets available for quick realization in cash, corresponding to such a fund, it is nothing more than a name.

The great English steamship companies, which are peculiarly subject to heavy losses through the sinking of their vessels and similar accidents, have for many years made it a practice to build up surplus funds consisting of outside investments. These funds are intended as a kind of insurance against marine losses that cannot otherwise be insured, and also for the purpose of "dividend equalization."

One trouble with this policy is that it necessarily results in tying up a portion of the capital of the company in assets which yield only a small return. If the surplus fund is to be of any value for the purpose intended, it can be invested only in the best grade of marketable securities. Most companies which are prosperous and expanding do not feel that they can afford to take cash away from the business where it would bring profits of perhaps 10%, 15%, 20%, or more, in order to put it into securities that will yield at best 4 or 5%. Another objection is the fact that even this low yield does not necessarily guarantee that the company's capital put into investments will remain intact. The officials of a manufacturing enterprise are not expected to be investment specialists.

A somewhat striking instance is given in the record of the Boston Belting Company, a long-established and substantial New England institution, which has for many years kept up an 8% dividend on its stock. Some years ago the company received in settlement of a suit which it had brought against the City of Boston, a sum of approximately \$1,000,000. Inasmuch as the cash was not needed immediately in the business, and as it was not thought best to distribute it to stockholders, it was decided to invest it in certain securities, which were then considered high-grade. These securities included 1,000 shares each of the stock of the New Haven Railroad and of the stock of the Boston and Albany, besides other shares and bonds. In 1914, as a result of the drastic decline in all securities, and especially in those which had been purchased, it was necessary to charge off over \$400,000. Later an additional \$100,000 was written off. It is true, of course, that the stockholders, if they had received the cash, might themselves have made exactly the same mistake and would today be in no better position financially. But the feeling exists, it is understood, that hereafter it will be better for the company to distribute whatever cash is not needed and to remain strictly a manufacturing, rather than become in part an investment, institution.

In general, American thought and practice are not inclined to favor the diversion of capital and energy away from the essential and legitimate business of a company into outside investments. It is generally agreed that regular dividends combined with large—or at least adequate—savings out of annual income should be features of the financial management of most corporations. However, this belief is based upon the assumption that the surplus thus credited is needed for the development of the business and should in fact constitute the chief source of new capital. Wherever this assumption is unjustified, the general opinion would probably favor distribution of profits even though the rate may be irregular.

Surplus as a Source of Capital

In this country the accumulation of surplus out of earnings is conceived almost wholly as a source of fresh capital. As such it is to be contrasted with the policy of paying out all, or nearly all, the earnings in dividends and relying upon fresh issues of securities in order to obtain new capital when needed.

The great advantage of securing capital through issues of securities is that it may be more quickly obtained and thus advantage may be taken of conditions which favor rapid development. Assume that two competitive corporations start to do business at about the same time with the same amount of capital, and that one corporation depends solely upon its accumulating surplus for the capital with which to finance extensions, while the other corporation distributes most of its earnings in dividends but is successful in raising fresh capital by the sale of securities. If both corporations are able to work side by side in a normal way, it is probable that in the long run the first-mentioned policy will prove sounder and more profitable and that the stockholders in this first corporation will eventually reap the benefits of their self-denial. But possibly both corporations cannot work side by side. As they expand, one or the other is certain to get the mastery, to capture the market, and to drive its competitor out of business. Under these conditions it may well be that the second corporation, through its policy of selling securities, may be able to raise needed capital more quickly and thus secure the dominating position which is the goal of both, before the first corporation has made a good start.

Somewhat similar conditions frequently exist. A corporation formed to manufacture and sell a new device may find it vitally necessary to cover its field before some other device can be brought out and introduced as an effective competitor. Or a company may have in hand a project which is peculiarly

timely, such as accepting a new and profitable contract. In all cases where the element of time in developing a business is a factor of great importance, the advantage, as between the two methods of raising capital, rests with the method of issuing securities.

The great advantage, on the other hand, of securing capital through savings consists of the steadiness and soundness with which the business may in this way be developed. It will not suddenly spurt ahead—perhaps before adequate preparation has been made or before an effective organization can be brought together. It will grow, year by year, adding a new piece of machinery here, erecting an addition to its plant there, gradually increasing its organization until some day—almost to the surprise of its own founders—it finds itself a leader among its competitors. Something like this, as has already been intimated, was the history of the Carnegie Steel Company—in fact, this has been the history of probably 75% of the great industries of the country. The other 25% have been built up chiefly by the more rapid, more attractive, and more dangerous process of bringing together great sums of capital through the issuance of securities.

It has been remarked above that the effect of making additions to assets through the accumulation of savings is not only to increase earnings, but also to stabilize them. This is due chiefly to the operation of the general principle that a large volume of business spread over a wide range of territory is less subject to violent fluctuations than is a smaller volume of business.

Hidden Surpluses

The remarks in one of the earlier sections of this chapter as to the various sources of surplus may properly be taken to indicate reasons for questioning the validity of the surplus accounts which appear on the balance sheets of many corpora-

tions. If these alleged surpluses are based on revaluation of the company's assets or are derived from statements of earnings that have been exaggerated over a series of years, it may easily happen that on searching analysis and examination they will vanish into thin air. There is plenty of reason for a questioning attitude on the part of purchasers of securities when they are supplied with a surplus statement.

On the other hand, many old and well-established corporations may properly be said to have "hidden" or secret surpluses. The situation arises out of the practice over a series of years of understating net income; of making larger provision than is necessary for reserves; of writing down drastically the book values of assets, both tangible and intangible. The result obviously is that the balance sheet shows an understatement of the value of the company's assets; and this understatement constitutes a hidden surplus. If the balance sheet were revised so as to show the true values of the company's assets, the surplus account would be correspondingly increased.

In theory, the practice of understating the values of assets and carrying hidden surpluses is just as objectionable as the practice of overstating values. The real aim of the accountant and of the financial manager should be to see to it that the balance sheet tells the exact truth—neither more nor less—so that every creditor, every prospective purchaser of securities, may take action with his eyes open. However, this idea is not attainable and, since there must be an error on one side or the other, it is better to err on the side of understatement and overconservatism. Bankers and careful investors place a high value on a balance sheet that gives evidence of having been prepared with extreme caution or even pessimism.

Banking houses—and sometimes other firms as well—find it useful to carry certain surpluses in the form of undervaluations of securities and other assets in order to take care of

exceptional losses without disturbing the appearance of the balance sheet. If a bank suffers a serious defalcation, for example, it may be highly injurious to its credit to charge the whole amount directly against surplus, thus advertising to its customers and the world at large that it has met with a set-back. In case the bank has been carrying assets at an undervaluation, it may resort in such a case to a revaluation of these assets so as to increase them by approximately the same amount as the loss that is to be written off. When the next balance sheet appears it shows no difference except that the skilled analyst might be able to detect changes in the valuations of assets; but this is not usually possible.

Hidden surpluses have been known to exist, not because of an especial degree of conservatism on the part of directors, but because it is deliberately intended to deceive shareholders as to the real value of their property. The shareholder is induced to sell, when his shares are desired by those on the inside, at a bargain price. Usually the next steps are to show the full amount of the earnings and surplus—with perhaps some inflation—to recapitalize and to sell the new issues at a heavy profit.

This is a subject which will again be referred to in the chapters which discuss methods of exploitation.

CHAPTER XXI

BUDGETS

Nature and Types of Budgets

In handling governmental business in nearly all civilized countries, it is customary for the executive power to submit to the legislative power a detailed estimate of the prospective revenue and outgo for the succeeding fiscal year. This estimate is known as a budget. It may be described as a detailed income and expenditure statement made out in advance of the period which it covers; it is a prediction or a guide, not a record of results. In governmental practice it is customary to secure the approval of the legislative power after required revisions have been made; and thereupon the adopted budget in its final form becomes a binding appropriation of the expected revenue. The various departments of the government are not authorized to go beyond the sums appropriated to their departments in their expenditures for the fiscal year.

In private corporations the budget, except in rough and fragmentary form, has not been much used. There is a growing interest, however, in the application of the principle of the budget in some practical form with a view to forestalling the serious financial errors and miscalculations that so frequently wreck the careers of otherwise successful corporations. Many directors and treasurers of corporations consider the present practice entirely too loose and too near-sighted and are looking to the budget as a means of bettering these conditions. It should be possible to make detailed financial plans and schedules for a year or more ahead, just as it is possible for many companies to make detailed operating plans and schedules.

Budgets are divisible into two classes—those which are merely estimates for the benefit of the active financial managers and those which are adopted as binding appropriations. It is usually best to start by making budgets of the first class—unless there is some emergency which demands that a definite financial plan be adopted and adhered to—always having in mind the expectation that the budget will in time reach the stage of being either formally adopted or accepted by general agreement as stating the limit for the year's expenditures.

Use of Budgets

In spite of the obvious advantages of making a forecast of financial operations each year, the budget-making principle has not yet been generally adopted. In reply to questions on this point, the following expressions of opinion from leading accountants or accounting firms have been received:

We do not know of any commercial undertakings where a complete budget or complete appropriation, covering a year in advance, is made. We believe the practice is becoming more and more common of making partial budgets or estimates for the assistance of the purchasing and finance departments.

So far as my experience indicates, I do not think that the use of budgets is at all common in industrial and trading corporations. Certainly it is not true in anything like the sense in which a budget is known in municipal and other governmental affairs, although, of course, the making of specific appropriations for given units of construction or fields of operation is fairly common.

I think it can be safely said that nearly all concerns have some method of forecasting their financial requirements. They are not accustomed to speak of these, however, as budgets, and I hardly think they could be classified as such.

The purpose of every budget is to ascertain as nearly as may be the approximate cash requirements of the future, with a view to providing for such requirements or using any excess in reduction of borrowed monies.

It is my belief that the successful management of a business in these times, involves the conception of a budget, although the name may not be given to the deliberation out of which such a plan is evolved.

The proper conduct of every business demands that engagements should not be entered into in excess of a reasonable expectation of revenue available to protect them; so that I believe that in one form or another, either with or without the name, the principle of a financial budget is apprehended and adopted by very nearly all industrial and trading concerns even if it be not fully comprehended. I further believe that this principle is more distinctly recognized and practiced by concerns in a large way of business than by those which are smaller.

Our experience with budgets in industrial and trading corporations is limited; indeed, I do not recall at the moment that we have had professional relations with any such institution with a complete line of budgets, nor do we think that they are altogether practicable in their application to the operations of industrial or trading corporations, because of the fluctuations in trade conditions which would necessarily change the demands of operating cost. Budgets, however, are in general use for construction, improvements, betterments, and replacements by commercial corporations.

The fact is that I have never seen a budget plan or a formal and definite forecast of income and expenditure satisfactorily accomplished in any industrial or trading corporation. In an informal way, of course, many business people attempt it, but I believe that the forecast

which is made at the beginning of the year, is very apt to be obsolete and pretty much forgotten before the year has progressed very far.

In our experience we almost always prepare a budget covering a year's period.

It is clear from the extracts above that the desirability of using budgets more extensively has not as yet been thoroughly considered even by many highly skilled public accountants. It is also clear, however, that informal estimates for a year or more in advance (which are a crude form of budget) are customarily made by careful financial managers.

Objections to the Use of Budgets

A constantly recurring objection, not only to formal budgets, but to all attempts to make advance estimates, is that the volume of sales of most corporations is not under control, nor can it be foreseen. There is undoubtedly much truth in this assertion. Yet in the great majority of cases this difficulty is exaggerated. As a matter of fact, the manufacturer or trader should be able, within reasonable limits, to exercise a fairly close control over the volume of his sales; if not, his business is clearly on an extremely unsound basis. His percentage of sales expense to gross profits has presumably been definitely determined by past experience, or at least the normal percentage in his line of business must be known. While it is true that he cannot abruptly increase his business by the mere process of increasing his selling expenditures, he should be able to count, with some definiteness, upon certain steps looking toward the building up of his selling organization which should result in a proportionate increase in volume of business.

It is, of course, further true that in many lines of business extreme fluctuations take place from year to year, due to causes over which the industrial or trading corporation has

no control. Manufacturers of railway supplies, for example, are able to sell more of their product when the railroads are prosperous, and no amount of extra selling effort will prevent sales from falling off when business conditions are at a low point. To say, however, that these fluctuations will necessarily take place is not equivalent to saying that they cannot be foreseen. The budget-maker is not primarily engaged in planning to build up sales or regulate operations; it is his main business only to form a careful estimate of what the results of the company's expenditures are likely to be. In determining these results, he may give proper weight to all of the unfavorable, as well as the favorable, factors. If he is a really capable financial man, he will look forward to the probable economic conditions of the coming year and determine with some degree of accuracy whether they are likely to be favorable or unfavorable to his company.

Having in view, then, these three factors: (1) estimated expenditures during the coming year directed toward building up sales; (2) normal percentage of sales expense to volume of sales; and (3) probable effect of general business and financial conditions and other external forces on his line of business—the budget-maker should be able to form a much clearer estimate of the coming volume of business than would at first glance seem possible.

Once the anticipated volume of business is calculated, it is comparatively simple to calculate the expenses that are necessary in order to handle the estimated volume. The uncertainty as to the result of selling effort is the crucial difficulty to be overcome.

A related objection to budget-making sometimes raised is to the effect that the business cannot be expected to run in a uniform channel month after month, but will fluctuate widely, whereas the budget is usually based on the assumption of some degree of uniformity; consequently, it is said, the budget gives

a false notion of the actual course of affairs, even though it should by chance be fairly accurate in its prevision of total business for the year. This objection is of no vital importance. It tends simply to show that the budget should, in the first place, be made on a monthly rather than on a yearly basis, with a view to increasing its accuracy, and, in the second place, should allow a reasonable margin for various inaccuracies and unforeseeable fluctuations.

A third objection to all budgets is the alleged danger of introducing red tape and hampering the free judgment and action of operating officials, which is essential to an energetic and growing enterprise. The obvious answer to this objection is that the free and untrammelled action of sales managers, buyers, superintendents of factories, and other operating officials, has been probably the most prevalent cause of financial embarrassments. One of the main purposes of the budget is precisely that of bringing their activities into harmonious relation, not only with each other, but also with the financial policies and the financial resources of the business. If the establishment of a necessary and proper relation, and the insistence upon it, irritates operating officials and makes them feel that they are unduly restricted, it is only because their interests are too narrow. They are attending to the upbuilding of their own departments without having a real understanding of the situation and the needs of the business as a whole.

As a matter of fact, a definite and binding budget, which can be debated and settled by all the responsible officials and the directors of a company at the beginning of a fiscal year, is a highly effective method of securing the unitedness of purpose which is an essential factor in every efficient organization.

Necessity for Continual Revision

The objections above cited are all based on the assumption

that a budget once adopted is an absolutely inflexible and unchangeable strait-jacket from which no relief can be obtained until after the expiration of the fiscal year in which it holds good. If this were actually the state of affairs, the objections would have weight. But the efficient budget, as used by some corporations, is subject to continual revision.

First of all, it is made both on a yearly basis and on a monthly basis. The yearly budget enters into few details, but gives a comprehensive view of the anticipated income from various sources—the anticipated expenditures, together with the approximate result of the whole year's business.

Supplementing the yearly budget and controlled by it, are the monthly budgets, which enter into as much detail as may be required by the nature of the business, and make due allowances, so far as they can be foreseen, for the seasonal and month-by-month fluctuations which occur in every business. The month-by-month budget may be checked up at the end of each month against the actual results of that month; the causes of discrepancies may be noted; new contracts or prospects for enlarging or reducing business during the months immediately following, may be taken into consideration. With all these and other similar factors in full view, such revisions as are at the time required may readily be agreed upon.

It is quite probable that during the year wholly unexpected circumstances may arise which may make it necessary to discard the previous estimates and to make entirely new estimates. The point toward which the business vessel is being steered, may for such reasons be altered. It goes without saying that no budget or any other arbitrary set of figures should be permitted to stand in the way. But the fact remains that the vessel is actually being steered and is not merely drifting. The budget is the chart which the financial manager is expected to follow until he finds that new circumstances make a new or revised chart necessary.

Income Basis vs. Cash Basis

A practical question that must be answered before the budget can be prepared is whether it should be based upon income and expenditures or upon cash receipts and cash disbursements. Income and expenditure constitute the correct measure of profits and therefore should be used whenever the prime purpose of the budget is to control expenditure and to insure a satisfactory showing of profits during the ensuing year. Cash receipts and cash disbursements, on the other hand, measure the financial status and financial prospects of the business and should be used whenever the prime purpose is to make sure that the business will run on a basis that is financially sound.

In many lines of business the distinction is not of great importance, for the reason that the income and expenditure of each month tally closely with the receipts and disbursements of the month. But in other lines it would be disastrous to overlook the distinction. In reply to an inquiry on this point, a certified public accountant of high standing writes :

It seems to me that all successful plans for business must contemplate both prospective income and expenditure and prospective receipts and disbursements, and that emphasis as to which of the two is more important depends to a considerable extent upon the business.

For example, in the malting business it is expected that probably four-fifths of the year's sales shall be made within the three fall months, during which time contracts are made for deliveries throughout the year. In order to fill these contracts, very heavy purchases are made of barley as soon as possible after the harvest of the new crop. In this case, as barley is bought for cash, it will be seen that the current liabilities must be cared for out of prospective income, but, this being understood, the budget can be properly considered. At the same time the manufacturing costs and expenses might reasonably be expected to be cared for out of current receipts.

In the business of making fertilizers, probably 85% of the business is done on long terms and the realized income receipts at the time of the greatest manufacturing activity are comparatively small. In such a case the income and expenditure features are those which are mainly considered. These same facts apply to a considerable extent to the conduct of the farm implement business.

On the other hand, any concern doing a strictly trading business, with little or no manufacturing, looks more to the expected receipts from current sales than to the anticipated income arising through a longer period. Nevertheless, even in such cases, especially where goods are bought on time, the anticipated income has to be considered in determining the amount of obligations which are incurred. For these reasons I am led to think, speaking broadly, that in the cases where a considerable part of the business, whether of sales or purchases, is done within a short period, the income and expenditure features demand the larger consideration, for broad plans must be devised for the whole year's business. Where the business, however, approaches more nearly to regular periodical turnovers, the receipts and payments become more important.

The best answer to our question would seem to be that in all cases except those in which income and expenditure and receipts and disbursements are practically identical, there should be two separate budgets. The income and expenditure budget should be for the guidance of all the operating officials of the company; it should show in some detail the amounts that may be expended and the results that are expected in each department. This is the budget that serves the purpose of facilitating control.

The receipts and disbursements budget may be only for the private information and guidance of the treasurer, or of those who are responsible for the financial management of the company. It will indicate just where the actual cash receipts

of each month are to come from and through what channels the cash is to flow out.

The budget of cash receipts and expenditures may itself be divided into two parts, the first part including only those transactions which have to do with current operations, and the second part including only capital transactions. By combining the two parts the financial management may look ahead and make certain that ample bank balances will be maintained; calculate to what extent they will be dependent upon bank and other loans; determine exactly how far they should go in taking advantage of cash discounts; and otherwise guide the financial course of the company with skill and accuracy. The blundering and indecision which so often mark the relations between business enterprises and their banks, and which so often lead to impetuous and urgent demands for fresh capital in order to avert embarrassments, could for the most part be avoided through the use of careful budgets of forthcoming receipts and disbursements.

Income Budgets

Taking up now in more detail the procedure in forming a budget, first on the income and expenditure basis, and second on the receipts and disbursements basis, we have to consider the extent of the income for the period (whether it be monthly, half-yearly, or yearly) which may fairly be regarded as assured. Manufacturing companies are likely to have certain regular customers on whom they may safely count, unless extraordinary conditions prevail, for a given amount of business. The same thing is true of wholesale trading companies. The companies, both manufacturing and trading, which are selling at retail, can at least work out from their own records the minimum limits of their sales. The same thing may be done by public service and transportation companies. Companies which operate on long-term contracts

extending over two or three years or more may conceivably be in the position of having all their capacity occupied with contracts previously arranged, in which case all their income will be assured.

Most companies have in addition certain possibilities which require careful study and good judgment in order to make possible a reasonably accurate estimate of earnings which are not assured but are probable. In making up these estimates, the financial manager will naturally be guided to a great extent by the views of the sales manager and other operating officials who are probably in closer touch than he is with the company's sources of income. It is well to state separately the amount of gross earnings which may be regarded as probable but is not assured.

It may or may not be advisable to make still a third classification which will include the additional earnings that are within the range of possibility, but cannot conservatively be called "probable." Naturally the form in which these earnings appear in the budget will depend upon the business.

In given instances it may be well to show considerable detail as to the exact basis of the estimates of earnings. However, if sufficient detail is not given in the budget itself, it should be at hand and should be subject to the criticism of the operating officials, with a view to making it as complete and accurate as possible.

The classification of expenses should follow the same lines of division. It is well to estimate, first of all, what may be called the fixed and necessary expenses of the business, assuming usually that it is intended to hold intact the organization that has been built up. These necessary expenses will include, therefore, the salaries of officers and their assistants, of salesmen, clerks, and working men, the purchases of raw materials necessary for production up to the amount that is assured, the up-keep of the plant, and other necessary expenses.

A second section will show the increase in expenses necessary in case the probable volume of business, as previously estimated, is secured. A third section will show further increases necessary in case the possible volume of business is attained.

An income and expenditure budget made up in these three divisions will prove, it may safely be said, a remarkably interesting and helpful guide. Possibly the three-fold division may be necessary only for the annual budget, while the month to month budget may relate wholly to probable earnings. These are matters of detail. The important point is to get the budget so arranged and in sufficient detail to show what may reasonably be anticipated without incurring the danger of imposing undue or arbitrary restrictions on the initiative of the various officials and department heads.

Cash Budgets

The receipts and disbursements budget may be arranged in three divisions to correspond; or it may be necessary to base it wholly upon the estimate of possible earnings. In those lines of business, however, in which sales are made on a long-term or instalment basis, it will be found of the highest importance to make the receipts and disbursements budget in considerable detail and with a view to all possible contingencies. Not to do so is to invite serious trouble, for an enlarged volume of business in such industries necessarily means a proportionate or more than proportionate tying up of cash resources. A budget may even indicate that for this reason it is unwise to attempt to handle the volume of business which the sales manager and operating officials would like to secure. The making of a receipts and disbursements budget may be sufficient in itself to reveal the breakers ahead and to inspire caution.

A remarkable example of lack of foresight in handling

the affairs of a prosperous business is to be found in the record of the M. Rumely Company, large manufacturers of farm machinery, which became embarrassed in the spring of 1913 and was reorganized a few months later. The first report of the president of the reorganized company, C. S. Funk, which covers the fiscal year ended December 31, 1913, is remarkable in its clear-cut analysis of a bad financial situation.

The business of the company is transacted by selling agricultural implements, through agents, to farmers and accepting instalment notes from the farmers in payment. The company in turn issues commission certificates to the agents, which are due and payable when the notes for the sale on which the commission is being paid, mature. As a certain percentage of these notes are not paid promptly at maturity and considerable collection expense is required, it is necessary to carry a reserve against them.

The heavy loss during the year preceding reorganization, which amounted to \$1,407,000, was explained in part by the lack of co-ordination between the sales and manufacturing departments. During the early months of the year, owing to the forcing of sales, the factory had to run night and day, which involved excessive piece rates, unskilled help and waste at every point. On the other hand, during the latter part of the year, the factory was shut down, the loss from manufacturing alone approximating \$1,100,000. The report says:

In the Sales Department a fundamental mistake was made in complete misjudgment of the market for Rumely products and the rate of gross which could be safely attained. The reduced volume of business should have shown a reduction of sales expense of \$600,000, to maintain the same ratio which held in 1912, but there was an actual *increase* of \$600,000, thus making a relative increase of \$1,200,000.

Interest charges were increased by over \$800,000, due to an excessive inventory and the high interest necessitated by the company's condition.

The company's embarrassment was directly due to the accumulation of a large inventory of raw material, goods in process and finished products, to the amount of \$16,500,000. The expected increase in the company's business failed to materialize and the sales expense was greatly increased "in an ill-advised effort to dispose of this product."

Surely a little foresight and care in drawing up a cash budget prior to the beginning of the year 1913 would have been sufficient in itself to assure a reasonable degree of co-operation between the sales and manufacturing departments during the year, and such foresight would have prevented the extraordinary absorption of cash reserves in running expenses and inventories which inevitably culminated in receivership.

A Manufacturer's Methods

In a paper of great value on the subject of "Budget-Making," presented before the Convention of the Efficiency Society, September 17, 1914, F. R. Hazard, president of the Solvay Process Company of Syracuse, N. Y., presented some results of his own experience and thought. Following are extracts which give some of the principal points in Mr. Hazard's paper and which will be of especial interest in connection with what has been said above:

In attempting to prepare a budget for any manufacturing business it is necessary to estimate, first of all, the quantities of finished product which can probably be sold, since it is evidently not wise to manufacture largely in excess of probable demand, and certainly foolish to fall short of stock with which to meet inquiries. To begin a budget system for a going business which has

never had one, it is to be assumed that certain statistics can be made available. On examining the volume of sales for, say, five annual periods, it is easy to determine the rate of increase shown, and for the budget purpose it is fair to assume that an average rate so found will be maintained in the future, barring unforeseen commercial and industrial complications. While the individual records of any business thus form a fairly safe guide for its future conduct, a broader view of the entire industry is required, especially in those lines where the national or world consumption is rapidly increasing and in those industries which require a considerable time to prepare new plant for increased production. In an industry which shows for a term of, say, five years an average annual increase in the national consumption of 10%, it is necessary for each maker to increase his product in each year by 10% over the previous year if he would hold his proportion of the entire trade. Such increase means that in seven years each maker must double his output.

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The recorded experience of the past few years will give a very close idea of the selling price which it is possible to obtain. Aside from the income from sales of product, other items are to be taken into account, such as income from investments in stocks and bonds of other concerns, rentals, and sundry income. Summarizing the Income side of the budget, we then have:

Sale of Product, quantity, average price, amount
Income from Investments
Sundry Income

The Expenditure side of the budget includes the

Manufacturing Cost of Product
General Overhead Charges
Selling Expense

Under Manufacturing Cost we may make as many subdivisions as desired. Generally the following will be found sufficient:

	Total Consumption Quantity Price Amount	Consumption Per Unit Quantity Amount
Raw Materials A ..		
B ..		
C ..		
Labor		
Repairs		
General Expense ..		
Sundry Items		

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Labor employed in manufacture is the only cost item which, under the best conditions, can be purchased from month to month in exactly the right quantity for the production actually made. In practically all the other items there will be from time to time excessive expenditures which will be compensated by deficient outgo at some other time. The Store accounts act as a reservoir to receive measured additions and to deliver measured quantities.

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The monthly budget is intended to show the expected cash situation of the company. As it deals with the actual cash income and outgo, such items as depreciation and obsolescence have no place in it. We may outline it as follows:

	Dr.	Cr.
Cash in Banks	\$	\$
Petty Cash		
Proceeds of Sales Due		
Proceeds of Notes for Money Borrowed		
Proceeds of Sale of Bonds		
Proceeds of Sale of Stock		
Proceeds of Sale of Preferred Stock		
Sundry Income		
Cost of Raw Material to Be Bought		
Cost of General Supplies		

	Dr.	Cr.
Transportation Charges.....	\$	\$
Monthly Pay-Roll		
" Salaries		
Repayment of Loans		
Interest		
Construction		
Insurance		
Taxes		
Dividend on Preferred Stock.....		
" " Common Stock		
Sundry Disbursements		
Selling Expenses		
Balance Carried Forward		

It is, of course, understood that not all the above items will be found in the budget for any one month.

The preparation of an annual budget involves a forward estimate of a number of items. It is, however, most useful in that it permits the manufacturer to lay his plans ahead and to make all his arrangements for raw materials, plant, and labor with a fixed idea of the quantities and capacities involved. This has a tendency to regulate production and to keep both labor and plant occupied in the most orderly and uniform, therefore the most efficient, manner. It is evidently more economical to produce each month about the same quantities, than to run at a forced rate for one or two months and then drop below normal for a few succeeding months. Constant reference to previous budgets and comparison of present results with the former estimates will gradually produce a greater degree of accuracy in both the monthly and annual budgets. It is possible to make these estimates correct to within 2 or 3 per cent. Under normal conditions it is generally possible to follow very closely the programme proposed by the annual budget. When, however, commercial, industrial, and financial conditions are disturbed and paralyzed, as at this time, by a world-wide cataclysm, it may be necessary to greatly modify the general plan. The existence of the budget

gives a *basis for change* in either the upward or the downward direction. For the annual budget the two most important things to estimate are the possible production cost and the possible selling price.

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If desired, an annual budget may be prepared to show in a progressive manner the expected results for a series of years. This is extremely useful in an industry which shows a steady expansion and in which preparation for future increase in product requires perhaps two or more years of construction work. Such an industry must have its capacity ready when the product is required, but evidently it is only a loss of interest to complete it before the necessity arises. There is also the danger that plant prematurely erected may become obsolete by the time it is needed.

There is no particular secret or trick about budget work. The only requisite is to marshal the facts of past experience in orderly array and use them with care and common sense as a guide to the probable course of future events. While it will not be possible totally to accomplish the estimated results, it will certainly be a source of satisfaction to approach them closely. With each succeeding effort the margin of error will be decreased.

A useful budget depends, then, on statistics which have been much maligned only owing to their improper or unintelligent use. They are, in fact, excellent servants but poor masters.

CHAPTER XXII

FINANCIAL STANDARDS

Need for Standards

A man who keeps all his property in the form of cash and government bonds has comparatively little to worry or think about; but, on the other hand, he is not using his resources productively. As the same man proceeds with the development of some business enterprise, he puts more and more of his capital into the various forms of tangible and intangible assets which are required for the upbuilding of the business. Presently, if he is not careful, he may find himself short of cash and unable to meet his obligations, although he may be earning good profits.

The same tendency is present everywhere. The executives who are managing the financial affairs of a company cannot assist in making the business profitable merely by piling up unnecessary cash resources. They must be prepared to venture out into the main current of business affairs along with their associates. And as they venture farther and farther, the danger increases that their financial craft may be swept out of their control. It requires constant watchfulness and sound knowledge to steer a middle course between excessive caution on the one side, and rashness in financial management on the other.

It would be far easier to keep to this middle course if the safe channels were more clearly marked out. A manufacturer, for example, takes on a greatly enlarged volume of business with the result that his working capital is much reduced; he finds it difficult to determine with any accuracy whether this reduction is approaching the danger point or not; he has no definite rule or standard by which to guide his course.

Many such standards of operating and financial practice are established for particular industries by general consent. These standards are in many cases probably incorrect, but they serve to assist those who are forming and testing policies. For example, the percentage of cost of carrying on various lines of retail business, in comparison with the gross sales of the business, has been studied. It is generally said that the cost of conducting a retail book store is about 28% of the gross sales. Again, in many lines of manufacturing the percentages of prime cost, of overhead, and of selling cost, to the prices of the articles manufactured, are quite definitely agreed upon.

Unfortunately, general standards of financial practice are not worked out in any detail or with any approach to accuracy. At this stage it would be impracticable for any individual or private enterprise to attempt to collect and collate all the data that would be required to make our knowledge of standards of safe financial practice more complete and more practical. This is work to be done by associations of business men which have authority or permission to inspect the private records of thousands of business concerns. Thus the American Institute of Accountants, the American Bankers' Association, the Investment Bankers' Association, the United States Chamber of Commerce, and other bodies might properly co-operate in carrying through to completion investigations of this character. The result would be a definite determination of many standards which would be of the highest value to business executives, to bankers and other creditors, and to the whole business community in reducing the amount and seriousness of losses due to errors in handling financial problems. It would not, of course, be the object of such an inquiry as is here suggested, to establish inflexible rules that would be binding alike on all classes of business. There would be ample room left for individual knowledge, foresight, and discretion. The result would be simply to establish certain normal or typical relations,

such as cash resources in relation to current liabilities, total current assets to current liabilities, working capital to total capital, working capital to volume of business, the operating ratio, the relation of gross profit to sales, turnover, the relation of net profits to fixed and to contingent charges, of capital stock and of bond issues to gross volume of business, and so on. Having these standards in mind, the financial manager would diverge from them in his own practice only after careful consideration and with the full knowledge that he would have to convince his associates and his bankers of the soundness of his reasons. There would be little danger, as at present, of taking chances in mere recklessness or ignorance.

In the absence of a lengthy and thorough investigation by associations of business men along the lines above suggested, it is as yet impossible to do more than offer a few suggestions based upon studies of published balance sheets. These suggestions are obviously fragmentary, and are subject to the corrections and explanations that would doubtless be discovered in many cases through a detailed study of the accounts that are not published. The purpose of presenting these suggestions is chiefly to indicate more definitely how each treasurer or other executive in charge of finances, may test the soundness of the practice of his own company by making comparisons with similar companies. These informal tests, however inaccurate and inconclusive they may be, are often found to be a fertile source of suggestions for improvement.

Relation of Working Capital to Total Capital

Following are the percentages of working capital to total capital as shown in recently published balance sheets of a considerable number of prominent American industrial corporations, which have been selected practically at random. For convenience, these companies are divided, for the present purpose, into three groups: those having a proportion of

working capital below 15% of total capital being placed in the first group; those having between 15% and 35% in the second group and those having above 35% in the third group.

PERCENTAGE OF WORKING CAPITAL TO TOTAL CAPITAL

I

Mexican Petroleum Company	3.5%
California Petroleum Company	3.9%
Sloss-Sheffield Company	6.1%
Corn Products Company	6.7%
Pittsburg Coal Company.....	8.9%
Trow Directory Company	9 %
United Fruit Company	9 %
Union Bag and Paper Company	9.4%
Harbison-Walker Refractories Company	10 %
American Can Company	11.5%
Railway Steel Spring Company	13 %
International Paper Company	14.4%

II

Sears-Roebuck Company	15.1%
Butterick Company	15.6%
The National Enameling and Stamping Company.	15.7%
Distillers Securities Company	16 %
United States Steel Corporation	16.2%
Pressed Steel Car Company	18.3%
General Chemical Company	19 %
Bethlehem Steel Company	19.4%
Goodrich Company	19.7%
Republic Iron and Steel Company	20.2%
May Department Stores	20.7%
New York Air Brake Company	21 %
American Steel Foundry Company	21.3%
Loose-Wiles Company	21.8%
National Biscuit Company	22.3%
National Lead Company	24 %
Lackawanna Steel Company	24.4%
Baldwin Locomotive Company	28.1%
Cambria Steel Company	33.5%

III

Studebaker Company	35.5%
Crex Carpet Company	36.8%
Armour and Company	37 %
American Woolen Company	37.4%
American Cotton Oil Company	37.7%
American Sugar Refining Company	39.6%
American Tobacco Company	42.8%
Peerless Motor Company	43 %
Underwood Typewriter Company	43.2%
General Motors Company	45 %
Central Leather Company	48.6%
Packard Motor Company	51 %
Swift and Company	51 %
Rumely Company	52.6%
Morris and Company	53 %
Ely and Walker Dry Goods Company	56 %
Eastman Kodak Company	57 %
W. H. McElwain Company	60 %
Deere and Company	70 %
International Harvester Company	81.3%

It is interesting to observe that, with one or two striking exceptions, companies which are competitive or which do the same general class of business have approximately the same relations of working to total capital. Note, for example, the close correspondence between the California Petroleum Company and the Mexican Petroleum Company. The only other company in the list which is engaged in the extraction of raw materials is the Pittsburg Coal Company, which also has a low percentage. Extractive companies have little need for large inventories, stocks of raw material, or other working assets, except cash and accounts receivable. And their accounts receivable do not run for long periods. The International Paper Company and the Union Bag and Paper Company are both in Group I; doubtless, owing to the fact that both companies manufacture from wood pulp, which is supplied by their

own forests, they have little occasion to carry heavy stocks of raw materials or inventories of half-finished products. The American Can Company, the Corn Products Company, the Sloss-Sheffield Company, the Harbison-Walker Refractories Company, and the Trow Directory Company, seem, on the face of the above showing, to have working capital considerably below normal. It is likely, however, that a more thorough examination would reveal reasons which are not now apparent. The United Fruit Company is, to a large extent, engaged in transportation rather than in producing and selling. As has been previously pointed out, transportation operations do not call for large amounts of working capital.

The various railway equipment companies, including the Railway Steel Spring Company in Group I and the Baldwin Locomotive Company, the New York Air Brake Company, and the Pressed Steel Car Company appearing in Group II, all have a low proportion of working capital compared with other industrial companies. It may be assumed that in railway equipment manufacturing, comparatively little money is tied up in accounts receivable. The railroad companies pay usually in the form of notes which are readily discountable, thus making unnecessary, for reasons that have previously been discussed, a large excess of current assets over current liabilities.

All the steel manufacturing companies, including the American Steel Foundry, the Bethlehem Steel Company, the Cambria Steel Company, the Lackawanna Steel Company, and the United States Steel, are included in the second division, and all except the Cambria Steel Company have working capital proportions below the average. We may again observe here, as in the case of the two paper manufacturing companies, that "integrated" production (that is to say, unified control of a complete series of operations from extracting the raw material to delivering the finished product) favors a low pro-

portion of working capital, as the necessity for carrying stocks of raw materials is much reduced.

The two biscuit manufacturing companies—Loose-Wiles and the National Biscuit Company—are approximately equal in respect to proportions of working capital. The other companies in Group II call for no especial mention.

In Group III are included a number of important companies which may be subdivided into two classes: those which find it necessary to carry large inventories or materials, goods in process, and finished goods, and those which find it necessary to sell on an instalment or long-term basis, so that accounts receivable are always heavy. The first-mentioned class includes American Sugar Refining Company, American Tobacco Company, American Woolen Company, Central Leather Company (the length of period of manufacture is exceptionally long), Crex Carpet Company, American Cotton Oil Company, W. H. McElwain Company, and Eastman Kodak Company. Some of the companies just mentioned also carry unusually large sums of cash.

The three agricultural implement companies in this group, International Harvester Company, Rumely Company, and Deere and Company, as well as the Underwood Typewriter Company, belong in the class which sell their products on long terms. Under the strict definition of the term, we should probably not allow the agricultural companies so large a proportion of working capital; for in arriving at this figure all accounts receivable have been listed under "current assets." These accounts, however, consist in large part of small notes running for one, two, and three years, and are hardly to be described, therefore, as "current." If we were to include only accounts maturing within three months, or even six months, our figures for working capital of these companies would probably show them in about the same condition as other industrial corporations.

The automobile companies, Studebaker, General Motors, Packard, and Peerless, like other manufacturers of automobiles, carry large stocks on hand, especially at certain seasons of the year. So long as this practice remains a necessary feature of the business, they will be required to carry large proportions of working capital.

The meat-packing companies—Morris, Swift, and Armour—find it necessary to carry large inventories of live stock and of goods in process.

On the whole, in running over the list that has just been given and in examining large numbers of other industrial balance sheets, it becomes fairly evident that well-managed business enterprises customarily follow standards that are more or less similar and that lead them to establish similar proportions of working to total capital. The exceptional cases, both above and below the normal proportions, are for the most part readily explainable. Each financial manager, taking the published statements of the firms that are most nearly like his own, will find it useful to make a similar comparison and, if possible, to explain satisfactorily the striking divergences either above or below the average.

Cash and Cash Resources

Closely related standards and tests apply to the proportions of cash and resources immediately convertible into cash (principally securities held for sale) to total capital, to gross volume of business, and to current liabilities.

Inasmuch as banks are devoted almost exclusively to handling cash and credit, we should naturally expect that their practice in respect to these factors would be more definitely standardized than the practice of mercantile manufacturing companies, and this is actually the case. The experience of financiers over many generations has gradually crystallized into the conclusion that in an ordinary commercial bank, which

is effectively using most of its capital in its own business, that capital ought to be invested chiefly or wholly in cash or at least in cash and secondary reserves immediately convertible into cash. The proportion of cash to demand liabilities has been fixed by long experience at from 15 to 25%.

The practice of industrial concerns in handling cash is, of course, on an entirely different basis and is not so readily standardized. The proportion of cash to total capital varies from as low as 1% to as high as 16%, which has been attained by the General Electric Company. It very seldom, however, runs higher than 7 or 8%, which is considerably above the average.

The remarkable discrepancy between the practice in this respect in the United States and Canada should be noted. In the last-named country the relations between banks and industrial enterprises are much closer than is customary in the United States. The Canadian companies depend much more largely upon bank borrowings to restore their cash balances whenever they become depleted. Nor do the banks impose the requirement, which is customary in this country, that bank balances should average at least 20 to 25% of bank loans. Take for example the report of the Ogilvie Flour Mills Company, Limited, for the year ended August 31, 1914, which shows current liabilities of \$1,807,503, divided as follows:

Bank of Montreal	\$863,885
Accounts payable	823,368
Provision for bond interest and dividends	120,250
	\$1,807,503

Current assets amount to \$3,153,998, which is a figure that shows an ample margin of current assets above current liabilities. Cash on hand, however, is only \$54,684.

In a recent balance sheet of the Ames, Holden, McCready

Company, Limited, bank loans amount to \$1,629,000, and cash on hand and in banks to \$36,979. The Canadian Cement Company, with a total capital of over \$32,000,000, had, on a recent balance sheet, cash of \$25,365. The Western Canada Flour Mills Company on a recent date had bank loans of \$474,293 and cash of \$26,382. It would be useless to multiply examples of this general practice. Evidently the financial managers of Canadian corporations are accustomed to assume—no doubt with entire safety—that their banking connections will take care of their cash requirements. This is in line with the practice in most European countries, particularly in Germany, and with the practice of European corporations operating in South America and other foreign countries. Canadian practice emphasizes the suggestion that the proportions of cash and cash resources to capital, sales, and liabilities, depend largely upon the nature of the company's banking connections. Or, to repeat the phrase used in a preceding chapter, the required amount of cash depends upon the "convertibility into cash of other working assets."

In most American industrial companies, the proportion of average cash to gross sales is about 3 to 6%. If the company is paying its bills promptly and is not overborrowing, current liabilities should not exceed 20 to 30% of annual sales. This refers, of course, to the business of manufacturing a standard article or articles which can be sold in fairly steady volume. On the basis of these figures, cash and cash resources should be about 12 to 25% of current liabilities, and this is not far from the customary showing.

Turnover

The definition of the term and the reasons for laying great importance upon quick turnover have previously been discussed. The additional point that belongs in this chapter is a statement as to the ratio of turnover which may be accepted

as standard in various lines of business. This statement is by no means complete or conclusive, but is based upon the fragmentary information which it is now possible to obtain from the records of business firms.

A cotton goods commission house which does a little financing of sales, employs some traveling salesmen, and carries no stock, has total working assets of \$400,000. The annual sales of this house are about \$3,500,000, showing a turnover of nearly 900%. This is regarded as a good, though not abnormal, showing.

A large department store is said to carry an average stock of \$8,000,000 to \$10,000,000, and to have average sales of \$15,000,000 to \$20,000,000, showing a turnover of 200%.

It is said, on excellent authority, that many retail grocers make a complete turnover at least once a month, equivalent to 1,200% for the year, while country stores, which are forced to carry a large assortment of stock, are well satisfied to do 300 to 400%. One small retail store is recently reported to have done 900%, but this is an extraordinary showing.

In manufacturing companies, turnover is an element of so much less importance relatively, that comparatively little attention has been paid to attempting to determine standards. It would be unsafe to rely on published balance sheets and income statements as the sole source of information in figuring turnover, inasmuch as the working capital of most concerns varies considerably from one season of the year to another and a comparatively slight variation would make a large difference in the results of the calculation.

Operating Ratios

One of the most important standards or tests of efficiency in all lines of business is the percentage of total expense of running the business, including manufacturing, selling, and administrations, to the gross sales—more commonly known

as the "operating ratio." It is clear that the difference between 100% which represents gross sales and the operating ratio is the percentage of gross profit on sales. The lower this percentage of gross profit—or, in other words, the higher the operating ratio—the more unstable, other things being equal, is the business as a money maker; for a high operating ratio means that even a slight variation in expenses may be sufficient to transform a profit into a loss. On the other hand, a phenomenally low operating ratio indicates a business which is earning excessive profits and is therefore peculiarly subject to competitive attack. The operating ratio should always be compared with the capital investment and the fixed charges of the business, which should not, however, be included in calculating the ratio. Although the operating ratio may be regarded as not primarily a financial factor, and certainly is not directly subject to control by the financial management of the company, yet it is an element of so much importance that it requires careful consideration both by the operating officials and by those who are primarily interested in accounting and finance. Moreover, the financial manager, through playing his part in raising new capital or in providing for betterments, may render excellent service in the effort to reduce operating ratios.

The term was first applied, and is still most generally used, in connection with steam railroads. The ratio here is low, usually not more than 70%; sometimes it climbs to 80% and 90%, and sometimes falls as low as 55%. This low ratio is offset by high fixed charges. In 1906 the ratio of the Chicago, Rock Island and Pacific Railway went up to 89%, and in 1907 to 87%. The ratio for electric railways decreased from an average of 60.1% in 1907, to 58.7% in 1912. The lowest figure was 57.5% in 1902. However, the operating expenses for 1912 included over \$7,000,000 charged for depreciation, compared with no similar charge for the earlier

years. Some recent ratios of industrial companies are the following:

The Shawinigan Water Power Company	14%
Westinghouse Air Brake Company	61%
American Piano Company	64%
Sears-Roebuck Company	89%
American Steel Foundry Company.....	90%
F. W. Woolworth Company	91%
Wells-Fargo Express Company	93%
American Express Company	94%
Kresge Company	94%
Adams Express Company	97%
Hart, Schaffner and Marx	97%

Other ratios might be given *ad infinitum*, but it would be useless to go farther here than to indicate roughly some of the considerations which enter into determining a satisfactory operating ratio for any one business.

As already indicated, a company which requires a large amount of fixed capital and which has, therefore, heavy fixed charges, but light operating charges, should normally have a small operating ratio. The extreme case above cited is that of the water power company.

Companies which manufacture specialties that enjoy a ready market and are protected by patents or otherwise from effective competition, may properly have a light operating ratio and an unusually large percentage of profit on sales. This is presumably the case with the Westinghouse Air Brake Company and perhaps with the American Piano Company. Normally, a manufacturing concern will have a ratio not far from 90%, as shown in the above list by the American Steel Foundry Company. Trading companies, such as Sears-Roebuck, the Kresge Company, and the F. W. Woolworth Company, run as high or even a little higher. The three express companies, and particularly the Adams Express, are running

on a dangerously close margin, due to the persistent rise in expenses and reduction in revenue during recent years. Formerly a ratio of 87 to 93% was about normal.

Hart, Schaffner and Marx is a good example of a firm which is manufacturing a staple (men's clothing) for which there is a steady demand and which can afford, therefore, to work on a narrow margin of profit. It may well be, however, that the 3% margin above indicated is too small and is due in part to a temporary state of overcompetition in this industry.

The man who is thoroughly familiar with a given line of business and who knows with some definiteness the normal percentage of profit that is required in order to make the business safe and profitable, will not fail ordinarily to look to the operating ratio as his first significant test of any company's financial status.

Stock and Bond Issues in Relation to Gross Earnings

Assuming that the operating ratio of a company is not far from normal in its line, a fairly definite relation may be sometimes established between gross earnings and stock and bond issues. In the chapter on capitalization (Chapter VIII) it has been suggested that industrial companies frequently show a total capitalization approximately equal to their gross earnings. This relation may easily exist wherever the percentage of profit on sales is about equivalent to the percentage of profit expected on capital invested in that industry. Inasmuch as companies which carry on a business that involves considerable fluctuations and risks expect a high percentage of profit both on sales and on capital invested, it is clear that the correspondence between gross earnings and capitalization is not purely accidental.

Wherever the operating ratio, however, leaves a margin of profit on sales that is either much higher or much lower

than the expected rate on invested capital, this relation of equality between gross earnings and capitalization will not exist, but will be supplanted by some other fairly stable ratio. Companies which do a large business on a small margin—commission houses, retail stores, manufacturers of staples, and the like—will customarily have a capitalization much smaller than gross sales. Companies like railroads, interurban lines, and public utilities, which have a low operating ratio, will customarily have a capitalization of several times their gross earnings. Electric street railway companies normally have a capitalization of four to six times gross earnings. Following are the ratios of total capitalization to gross earnings, and also of bonded indebtedness to gross earnings, of some of the principal railroads in the United States, as computed by the *Wall Street Journal*, issue of August 15, 1915:

EASTERN ROADS

	Total Capital- ization to Gross Earn- ings	Bonded In- debtedness to Gross Earnings
Pennsylvania Railroad	3.31	1.21
New York Central	5.17	2.42
Baltimore and Ohio	5.58	3.81
Pennsylvania Company	3.77	2.12
Lehigh Valley Railroad	4.08	1.73
Average	4.31	2.14

SOUTHERN ROADS

Illinois Central	3.69	1.68
Atlantic Coast Line	3.81	2.56
Nashville, Chattanooga and St. Louis	2.96	.74
Louisville and Nashville Railroad..	3.69	2.74
Average	3.66	2.16

NORTHWESTERN ROADS

	Total Capital- ization to Gross Earn- ings	Bonded In- debtedness to Gross Earnings
Union Pacific	4.79	3.06
Northern Pacific	6.04	2.78
Chicago and North Western.....	4.28	2.52
Great Northern	4.72	1.49
Chicago, Burlington and Quincy....	3.24	1.86
Average	4.52	2.35

WESTERN ROADS

Southern Pacific	5.25	3.17
Atchison	5.56	2.80
Union Pacific	4.79	3.06
Average	5.23	3.07
Average for Railroads in the United States	5.11	3.17

A little figuring based on the normal operating ratio and the normal relations of gross earnings to capitalization in any given line of industry, will often prove an exceedingly helpful method of testing in a rough way the capitalization that will be proper for a given enterprise.

A Comparative Study

An interesting comparative study of efficiency in financial management may be made of the five greatest electric manufacturing companies in the world; three are in the United States and two in Germany. Taking the latest figures available up to June, 1914, we have the following relation between gross sales and capitalization, including with capitalization, in this case, the surplus of each company.

	Gross Annual Sales	Outstanding Capital Stock	Outstanding Funded Debt	Surplus	Total Capitalization and Surplus	Percentage of Gross Sales to Total Capitalization and Surplus
<i>American Companies</i>						
General Electric Co..	\$106,477,000	\$101,381,000	\$20,152,000	\$16,940,000	\$138,473,000	77%
West'ghouse Electric & Mfg. Co.....	43,734,000	40,699,000	30,253,000	7,659,000	78,611,000	56%
Western Electric Co.	77,533,000	15,000,000	15,000,000	27,386,000	57,386,000	135%
<i>German Companies:</i>						
Allgemeine	100,590,000	36,890,000	26,788,000	25,609,000	89,287,000	113%
Siemens & Halske...	70,000,000	15,000,000	10,939,000	7,510,000	33,449,000	209%

The Westinghouse Electric and Manufacturing Company is a little out of step with the others, because of its two reorganizations which have resulted (as do most reorganizations) in enlarging its capitalization far beyond the point that would otherwise be normal. There is, however, a somewhat remarkable parallel, considering the wide variation in economic conditions and in financial practice, between the General Electric and the Allgemeine, and between the Western Electric Company and Siemens & Halske. The business of the two companies first named runs along lines that are closely parallel, and in many international markets they meet as direct competitors. The Western Electric Company confines itself quite closely to manufacturing supplies for American telephone and telegraph companies, while Siemens & Halske not only manufacture telephone instruments, but also many other electrical appliances. Basically, however, the two companies exercise similar functions.

The operating ratio of the General Electric Company is such that it can have outstanding a capitalization and surplus considerably higher than its gross earnings, and yet is able to earn well over 10% on its total investment. Judged by American standards and having in view the market prices of its securities, this company is certainly not overcapitalized and may even be considered a trifle undercapitalized. The Allgemeine Electricitäts-Gesellschaft has a very low capital stock issue. Its net earnings are about equal to those of the General Electric Company showing that it works on a somewhat lower operating ratio. The percentage of net earnings to its total of capitalization and surplus for the period above referred to was over 17½%. Judged by American standards, therefore, this company is undercapitalized. However, both the American and the German companies tend to conform within reasonable limits to the standard relations between gross earnings and capitalization that have been suggested.

In the type of business carried on by both the Western Electric and Siemens & Halske, the operating ratio is considerably higher and the net earnings, even on an investment in both cases which is comparatively small in relation to gross sales, are quite low, being 7% in the case of the Western Electric and 8.6% in the case of Siemens & Halske; consequently, neither company can be called undercapitalized. Except for the much larger surplus of the Western Electric, there is a striking parallel between the two companies. As for the Westinghouse, its net earnings on its capitalization and surplus are less than 5%. The company is, therefore, clearly overcapitalized on the basis of this showing. However, this does not take into account prospects for improvement in its status.

Analysis Based on Financial Standards

Bankers, credit men, investors, and others who are not intimately acquainted with a given business, are frequently called upon to form tentative judgments as to the financial efficiency of a business, based chiefly upon statements of account that are furnished to them, or even upon a few unconnected figures. The process of piecing together these fragments and from them forming a fairly definite mental picture of the status and efficiency of the concern, is not unlike the work of those scientists who from a few small bones are able to reconstruct the skeleton of some prehistoric animal. In making an analysis and "reconstruction" of this kind, it is helpful to be guided by whatever financial standards are available which apply to the business under consideration.

Following is a request from the general manager of a wholesale house for expressions of opinion on certain questions of the financial management of his business:

The questions apply to a firm having a paid-in capital of \$125,000, having been in business three years with an approximate surplus of \$25,000. Of this capital, \$35,000

is invested in a store building, warehouses, furniture, drays, and general equipment necessary for the carrying on of said business. We have approximately \$90,000 stock and the surplus in working capital. The credit of the firm is \$125,000 to \$200,000 high credit.

1. What is the average stock of merchandise the business referred to should have at all times.

2. What maximum open accounts would be conservative for this business to carry? Goods sold at 60 days' time, 75% of the business sold to merchants with good credit, 25% of the business retail, principally city accounts collected on first of each month after purchase.

3. What maximum amount of bills payable should our books show for borrowed money, goods, etc.?

4. What amount in bills receivable would be conservative at any one time?

5. What would be the maximum amount of yearly business such a firm should do for capital invested?

6. What amount of dividends should stockholders be paid, the average net earnings of the firm being 25%, after all expenses and losses are paid and accounted for?

On the basis of this somewhat scanty information, the following reply was sent:

As I understand the situation, a highly condensed balance sheet of your business would read somewhat as follows:

Assets

Building, Furniture, and Equipment.....	\$35,000.00
Stock	90,000.00
Working Capital	25,000.00
Total Assets	\$150,000.00

Liabilities

Capital	\$125,000.00
Surplus	25,000.00
Total Liabilities	\$150,000.00

The \$25,000 working capital must consist partly of cash and partly of an excess of accounts receivable over accounts and other obligations payable.

In order to prepare an opinion that would fit your case I should have at least the following information:

- Normal amount of cash in bank.
- Normal amount of accounts and bills payable.
- Normal amount of accounts and bills receivable.
- Average percentage of gross profits.
- Average operating expenses per month.

As I do not have these facts, I will make the following assumptions:

Normal Cash Balance	\$10,000.00
Normal Accounts and Bills Receivable	90,000.00
Normal Accounts and Bills Payable.....	75,000.00
Average Operating Expenses per month.....	15,000.00
Average Gross Profits (on selling prices)....	25%

Very likely these assumptions are a long distance from the facts. That, however, will not affect the reasoning; you can readily fill in the right amounts and thus make the figures suit your situation.

With these assumptions, your balance sheet would read as follows:

Assets

Building and Equipment	\$35,000.00
Stock	90,000.00
Accounts Receivable	90,000.00
Cash	10,000.00
Total Assets	\$225,000.00

Liabilities

Capital	\$125,000.00
Surplus	25,000.00
Accounts Payable	75,000.00
Total Liabilities	\$225,000.00

The above balance sheet on its face would indicate, in my judgment, a fairly strong financial position. Your quick liabilities would be only 75% of your quick assets, not counting stock most of which is no doubt readily salable. This percentage in mercantile companies and in those manufacturing companies that carry large inventories of finished products is generally considered conservative. The percentage in emergencies or at certain seasons of the year might rise as high as 85% or even 90% without indicating recklessness, but this high ratio should be short-lived.

Another ratio to consider is that between quick liabilities and the total of current assets, including stock. It is safe to say that this percentage should not normally be higher than 50%. I have recently gone over the balance sheets for a period of years of a large wholesale dry goods company, which showed a ratio of quick liabilities to total quick assets at the end of each fiscal year as follows: 40%, 55%, 40%, 57%, 45%, 40%, 38%. In the above assumed balance sheet, the total current assets is \$190,000, and of quick liabilities, \$75,000, or less than 40%. This is conservative enough.

Buyers of commercial paper, especially large banks, sometimes make an arbitrary requirement for a definite ratio. In Babson and May's treatise on "Commercial Paper" the following rule is laid down:

"Two and a quarter of quick assets, that is, assets which can be converted readily into cash, to one of debts, have been taken as a fair showing to be called for on an annual statement The ratio of $2\frac{1}{4}$ to 1 should be regarded as a fair ratio to be expected on the statement of the average mercantile company, and most borrowers of this class in the open market, under our present system of commercial paper, ought to show this much."

Going back to the hypothetical balance sheet, it is obvious that the gross volume of business which can be carried on with safety is to be determined only by a study of the proper relations of the various assets and liabilities to each other. To illustrate: make the assump-

tion (which is, of course, out of the question) that the gross sales in the month following the date of the above balance sheet should amount to \$100,000. What would be the effect on the business? First, goods of a cost value of \$75,000 would have been sold and would have to be replaced. In addition, with this volume of business, the stock on hand would obviously have to be increased to say \$125,000. This would make it necessary to buy during the month \$110,000. Assume that \$50,000 of the \$90,000 accounts receivable fall due during the month and that \$40,000 of the accounts payable become due, then the cash receipts would be \$50,000 (assuming that there are no cash sales), \$15,000 of which would go for operating expenses, leaving \$35,000 to apply toward the accounts payable; it would be necessary in addition to draw \$5,000 from the cash on hand. We must, of course, assume that such a volume of business would require an increase in equipment which we may assume to amount to \$5,000. The condensed balance sheet at the end of the month would then be as follows:

Assets

Building and Equipment	\$40,000.00
Stock	125,000.00
Accounts Receivable	140,000.00
Total Assets	\$305,000.00

Liabilities

Capital	\$125,000.00
Surplus	35,000.00
Accounts Payable	145,000.00
Total Liabilities	\$305,000.00

Evidently this would be an impossible situation. It appears absurd enough when put in this exaggerated form; yet a considerable number of firms, as you have probably observed many times, gradually work themselves into a situation somewhat like this by trying to

carry a volume of business which is far beyond their capital.

With no more facts than you have given and with only the above assumptions to work on, it is not possible to give an intelligent answer to your questions as to the amount of yearly business a firm of your size should do. Offhand, I should say that something like \$500,000 a year, \$40,000 a month would be some place near normal. I hesitate to name that or any other figure without knowing more about the situation.

Your first question as to the average stock of merchandise can be answered only with relation to your fifth question as to the maximum amount of yearly business. Your stock must be proportioned to the volume of your sales. Your sales must be proportioned to the equipment and working capital of your business.

It is not possible to answer your questions 2, 3, and 4 by giving definite figures, for the reason that the right amounts of receivables and payables are determined by the *relations* of these items to each other and to the other assets and liabilities of the business. I have tried to indicate above what are generally considered the right percentages; and also to indicate the line of reasoning that I should follow if I were called upon to pass judgment on any particular business, all the essential facts being laid before me.

In a mercantile business that is running on a sound basis and that is not increasing its volume of sales too rapidly, it is considered proper to pay out a fairly large proportion of its net earnings in dividends. If your net earnings are 25% and the volume of your sales is some place near the maximum, I should think that a dividend of 15%, or possibly even a little more, would not be out of place. The case is entirely different if your business is growing rapidly. In that case it is obviously necessary to reserve more cash and thus build up your working capital.

The comment following was included in the acknowledgment of the analysis above quoted.

I notice in your report that cash balance and normal accounts and bills receivable should be approximately \$100,000. To show how near you came to the actual facts, our recent trial balance showed in April \$96,000 covering these two accounts, approximately \$10,000 cash balance. Our liabilities at times will run something near \$75,000 though at present they do not show this much. The only figures I have reason to challenge in your report would be your expense account of \$15,000 per month. You no doubt have in view the handling of some very profitable line of goods. Our expense account showed in proportion to the sales $10\frac{1}{2}\%$, approximately \$40,000 per year. Your idea that a firm of our capital should do \$500,000 agrees with my own. In other words, a wholesale firm should, at least, turn its capital stock four times during its fiscal year.

From the above it is clear that through the proper use of accepted standards of financial practice it is possible to arrive at a fairly accurate understanding of the status of a concern even if only limited information is available.

Part V—Financial Abuses and Involvements

CHAPTER XXIII

EXPLOITATION BY OFFICERS

Exploitation Differs from Fraud

Fraud may be defined as a gross deception or breach of trust which operates to the injury of an innocent party. Fraud is recognized in law as giving a sound basis for invalidating a contract or for action to recover damages, and under certain conditions it may constitute a crime. Although it is notoriously difficult to prove the presence of fraud in a transaction, inasmuch as such proof nearly always requires evidence of an improper motive, yet a person who has suffered injury through fraud has nevertheless some legal opportunity to recover at least a portion of what he has lost.

Exploitation differs from simple fraud in that it is more subtle, more difficult to trace and expose, and ordinarily gives no grounds for legal action to obtain redress. In its study there is no one act or set of acts to be listed and definitely described; it takes an infinite number of forms and in many cases is never known or recognized even by its victims.

Nor is there any clear certainty, ordinarily, that a company has been deliberately exploited, even though it may have been wrecked and the facts as to its management may have become known. It may often be proved, of course, that those in charge of the company's affairs have secured personal profits and that the results of the transactions out of which they have made profits have been injurious to the company which they served. Yet the plea may always be made that mistakes of business

judgment are common to all enterprises and that it is easy to sit back and criticize after the results of a given line of action have become known.

Frequently such pleas are thoroughly sound and the criticisms made by stockholders of losing corporations are unjustified. There is no definite standard or simple rule which can here be applied. The facts as to every case where exploitation is suspected require careful study, and the judgment of an observer will frequently be based upon probabilities rather than upon definite facts. In general, exploitation may be said to differ from fraud in that, while the intended results are practically the same, there is always room, in case of exploitation, for argument and for widely varying interpretations of the facts.

Exploitation is in the twilight zone between legitimate business shrewdness and unquestionable fraud. It is this uncertainty which makes it dangerous. Because it may be so easily disguised, men of high standing and of undoubted personal honesty are easily persuaded to make themselves parties to the schemes of their less scrupulous associates. Because plausible arguments in favor of almost any business proposition can be advanced, it is seldom possible to arouse unanimous opinion and action against practices that savor of exploitation. Again and again it has been proved that in large enterprises comparatively few stockholders will vigorously support action intended to recover funds that have been lost by exploitation. Consequently, we often see the surprising spectacle of corporations being obviously mismanaged and deliberately exploited while the management is receiving the loyal support of the very stockholders whose property they are looting. It is only when the exploiters become overbold and take some action which brings them to the verge of actual fraud, that effective legal steps to put a check on their operations commonly are taken.

In view of what has just been said, it is clear that in this chapter and the chapter following, we can do little more than present typical examples of schemes of exploitation which may serve to indicate some of the methods that have been most frequently used in the past and which may be anticipated in the future.

The Corporate Form Favors Exploitation

Greed, trickery, and unfaithfulness to trust on the part of men of coarse moral fibre, combined with weakness or negligence on the part of their associates, are by no means new failings in human nature. There always has been, and doubtless will continue to be, exploitation by the powerful and influential of the needs of those who are helpless. But exploitation in its modern and now most prevalent form, as a factor in business life, is comparatively a new thing; at any rate, it has come to light and has been more generally recognized in its true nature within a recent period.

The general adoption of the corporate form of organizing business enterprises has opened up new and previously unthought-of fields and methods of exploitation. The corporate form is singularly well adapted for exploiting activities. Through the creation of a small corporation, an individual may wholly or partially hide his own identity and rid himself of personal responsibility. The large corporation with its thousands or tens of thousands of shareholders, few of whom know much about or take a personal interest in the fortunes of their corporation, offers an inviting opportunity for exploitation. It requires a man of really strong character and of unusual conscientiousness to avoid the temptation of using an important office in a corporation of this character for the prime purpose of building up his personal bank account. To the credit of corporate officers and directors it must be said that the great majority devote their undivided efforts to the service

of their corporation and the stockholders whose interests they represent.

The legal fiction of "corporate entity" which has been more rigorously upheld and applied in American courts than in English courts, has undoubtedly been a highly important factor in favoring exploitation. Any individual who so desires may readily organize and control a corporation in which he may not personally appear either as a director or an officer; indeed, he may not even be on the books as a stockholder of record. With this corporate mask over his face, the exploiter may go ahead boldly looking for victims, and may even, under this new guise, operate successfully on the pocketbooks of those whom he has previously robbed. Hundreds of so-called "promoters" of alleged mining and oil companies and of innumerable swindling schemes have made it their practice to work under the name first of one corporation and then of another. A fraud order from the Post Office or some other legal action may put a stop to the activities of one corporation without in the least harming the others; and even without seriously harming the individual who pulls the wires. So long as the courts are guided wholly by the rule that the corporation is an "entity" quite distinct from the people who organize and control it, there are no legal means of reaching the man who is really responsible.

Fortunately, the doctrine of corporate entity has never been carried to its ultimate logical conclusion. Of recent years, both the courts and the legislatures have strongly tended toward modifying the doctrine. There is a man or a group of men behind every corporation whom legal formalities no longer completely shield. As legal reasoning in this country slowly works toward the conception of a corporation which prevails in most other countries—namely, as an association of individuals for some specific purpose rather than as a distinct "artificial person"—the adaptability of the corporate form

to safe and easy methods of exploiting stockholders, etc., begins to decrease.

Furthermore, bitter experience combined with observation of many different cases is slowly educating shareholders and the share-purchasing public; and it is probable that the public is, on the whole, less easily fooled, more ready to defend itself, and better supplied with legal weapons than was formerly the case, though on this point there is difference of opinion.

These remarks are not intended to indicate that the evil of corporate exploitation has disappeared or is likely soon to disappear. On the contrary, it is flourishing and resourceful. While new weapons against it are being forged, it is assuming new and less vulnerable forms. And the recent exposures by the Interstate Commerce Commission of the financial histories of two great railroad systems—the New Haven and the Rock Island—furnish ample evidence that the old-time boldness and ruthlessness of the buccaneers have not disappeared.

Petty Abuses by Subordinate Officers

In a corporation which is conducted by able business men who are single-mindedly devoted to the upbuilding of the corporation, it is probable that nearly all subordinate officers will be of the same type. In the business world, as everywhere else, like attracts like. Men who are themselves honorable prefer to work under chiefs of the same type. If they suspect that their company is being exploited by its officers, they naturally seek an opportunity to leave and their places are taken by men who are perhaps less able or less scrupulous. There are, of course, innumerable exceptions on both sides, but the general rule holds good. Consequently, when we find a company in which the chief officers have been primarily engaged in exploitation, it is only too likely that petty graft will not be unknown among the subordinates.

Under the old regime of the New Haven Railroad Com-

pany, according to the report of the Interstate Commerce Commission, the company purchased its rolling stock almost exclusively and without competition from one man. This man sold the company approximately \$37,000,000 of equipment. He made no secret of his generosity in making valuable presents to the officials with whom he did business, but claimed that these officials were old friends of his. The Commission makes the following pertinent comment: "Corporate economy is not practicable where gifts and obligations arising from friendship tend to obscure official duty."

In another railroad system, some years ago, a shameful condition was found to exist among a surprisingly large number of the district superintendents, traffic officials, and others who had charge of placing and routing empty coal cars. Some of the coal-producing companies had presented blocks of their own shares to these men with a view to securing their favorable action in giving these companies first call on empty cars, which at that time were in great demand. Most of the shares that had been accepted by the railroad officials were returned and the affair was straightened out with a minimum of scandal. It is not believed that these instances indicated any lack of honesty or ability in the general management of the company's affairs.

The purchasing officers of large corporations are naturally subject to special temptations, inasmuch as they frequently control contracts of great importance. It is, however, a very rare occurrence to find even a tinge of suspicion resting on these men, almost all of whom command the complete confidence of their associates and of those with whom they do business. Their status may be contrasted with that of the purchasing agents of some of the European governments who, during the early months of the European War, placed contracts and were widely reported to have been in many cases approachable by improper means.

On the whole, the number of instances of petty abuses by

subordinates of corporations is so limited that this particular phase of our subject need not be pursued further. It is in the broader field of "high finance" that we shall find most of our examples.

Exorbitant Salaries

In a small corporation which has come into the control of one faction and is being exploited to the detriment of the general body of stockholders, the simplest and most common method is through payment of exorbitant salaries. So long as the salaries are kept within the bounds of reason and so long as the real purpose—which is to distribute profits in this form—is not made too plainly evident, this practice is legally unassailable. It may, however, become dangerous to the exploiters in case their salaries are suddenly jumped, or in case there is a rearrangement of salaries which so clearly corresponds to shareholdings as to leave no doubt that the increases are really mere devices for distributing dividends to the dominant faction at the expense of the other shareholders.

In the early days of the United States Shipbuilding Company, which was organized in 1902, there was considerable mystery as to the failure of the company to live up to the advance estimates of its profits. It developed that one of the most important subsidiaries taken over—the Union Iron Works—had been assumed to have a surplus of \$1,000,000, whereas it really had an accumulated deficit of about \$1,400,000. Furthermore, Receiver Smith discovered that the Shipbuilding Company had entered into contracts to retain certain officials at salaries aggregating \$240,000 per year. Most of these salaries were heavy advances over those which had previously been paid, of which the following are instances:*

Dewing's "Corporate Promotions and Reorganizations," p. 498.

Monthly Salary Before Formation of the Combination	Monthly Salary After Formation of the Combination
\$27.00	\$250.00
40.00	250.00
200.00	500.00
583.00	833.00
600.00	833.00

In its recent investigation of the affairs of the Rock Island Company, the Interstate Commerce Commission found that large extra and secret compensation was arbitrarily allowed to some of the chief officers of the company at various times, of which the following are examples:

The first vice-president, in charge of freight and passenger traffic, was secretly paid \$18,750 per annum, making his total compensation \$43,750, whereas the pay-roll showed \$25,000.

The chief engineer received a salary of \$15,000 per annum plus a secret bonus of \$3,000 on the first of each year.

Upon the retirement of the general solicitor, he was given a bonus of \$100,000 in cash.

As an inducement to a former chairman of the executive committee to relinquish after ten months' service a contract under which he was to receive a salary of \$75,000 per annum for a period of five years, and in addition was to be paid a bonus of \$500,000 at the expiration of the contract, he was given bonds of the railway company of a par value of \$450,000.

A vice-president was given by the railway company \$150,000 of common and \$105,000 of preferred stock and \$50,000 in cash. There was no board authorization for the latter expenditure.

A member of the executive committee received from the company bonds worth \$24,500 for his services in the acqui-

sition of another railway company, and was paid \$85,000 by the latter company in the same transaction.

A vice-president was given \$25,000 in cash.

The secretary of the board was given \$15,000 in cash when he retired from office.

It is perfectly true that some of the above transactions may be defended, but they at least illustrate with striking clarity the almost unlimited possibilities for abuse if a board of directors is inclined to be careless in its use of the property that is entrusted to its safe-keeping.

Contracts That Benefit Officers

The history of the Standard Rope and Twine Company, which was formed in 1895 to take over the assets of the insolvent United States Cordage Company, illustrates some of the possible methods of exploiting a corporation to the personal advantage of the officers. The first president was accused—whether justly or unjustly cannot be definitely determined—of discriminating against the Standard Company in favor of a competing concern in which he was a partner, turning the less profitable contracts toward the former and the more profitable ones toward the latter. In 1896 the president proposed that the Standard Company should take over certain processes controlled by him for forcing oil into rope. The company made a contract which gave the president authority to spend \$25,000 of the company's money in perfecting his invention, and, as a matter of fact, much more than this originally authorized amount was spent. In the end the process proved worthless and the company had to bear a heavy loss amounting to over \$126,000.

In September, 1898, some of the officers of the Standard Rope and Twine Company formed a selling agency known as the Union Selling Company. This last-named company then entered into a contract with the Standard Rope and

Twine Company under which it received $7\frac{1}{2}\%$ commission on all sales. A stockholders' committee in 1900 estimated that the effect of this contract was to increase by more than 50% the selling expenses of the Standard Company.*

One of the worst scandals in American financial history was that connected with the famous *Crédit Mobilier*. In 1864, while the Union Pacific Railroad was under construction, one of the vice-presidents through a "dummy" secured a contract for the construction of a large section of the line. This contract was assigned to the Pennsylvania Fiscal Agency, the name of which was later changed to "*Crédit Mobilier*." Stockholders of the Union Pacific were allowed to obtain *Crédit Mobilier* stock and thus become stockholders in both concerns. As a result of this arrangement, all incentives to economy of construction were removed. *Crédit Mobilier* obtained all the contracts it cared for on very attractive terms, and made profits variously estimated at from \$17,000,000 to \$23,000,000, in which the officers of the railroad had a large share.†

The misuse of "construction" companies as a means by which officers may make contracts for their own advantage has been a practice unfortunately not at all uncommon. Another almost customary method of "milking" railroad corporations a generation or two ago, was through the organization of "fast freight" or "despatch" lines which made particularly favorable contracts with two or more railroad companies for moving their cars on an express schedule and then picked up highly profitable quick despatch business from shippers. In a number of cases the stockholders in these lines were the officers and directors of the railroad companies over whose tracks they operated. It was many years later before the railroad companies stepped in and purchased the ownership of these lines.

*Dewing's "Corporate Promotions and Reorganizations," pp. 158, 159.

†Daggett's "Railroad Reorganization," pp. 223, 224.

Another common method for making contracts for the advantage of officers has been through the purchase at high prices of subsidiary or branch companies in which officers were personally interested. In 1890 the directors of the Northern Pacific who were, as individuals, also in control of the Wisconsin Central, effected a lease of the last-named road to the Northern Pacific for 999 years on certain terms which the stockholders' committee considered unfair to the Northern Pacific. The receivers of the Northern Pacific four years later, however, were unable to obtain sufficient information and evidence upon which to base legal action against the directors who had taken part in this transaction.*

Divergence of Business to Other Companies

A more ingenious and more insidious form of exploitation for the advantage of officers consists in the divergence of profitable business from the corporation which the officers are serving to another corporation in which their personal interests are larger. One example has been cited at the very beginning of the preceding section, where it is pointed out that the president of the Standard Rope and Twine Company was alleged to have diverted profitable contracts to his own firm.

The question as to when an officer is entitled to use for his personal benefit knowledge that comes to him in the performance of his duties and when he is under obligation to use it exclusively for the benefit of the corporation, is often puzzling. For example, the manager of a manufacturing concern has had brought to his attention a new device which is likely to prove highly profitable. The information comes to him as an individual, not as an officer. Is he entitled to organize a new company and to become personally interested in the manufacture of the device? Or is he under obligation to turn

*Daggett's "Railroad Reorganization," pp. 286, 287, 291, 292.

over the information he has secured to his company? As a practical matter, probably few would object if the officer, under such circumstances, were to drop his former connection and devote himself to the new enterprise.

This leads, however, to the next question: whether it would be proper for the officer to become interested as a stockholder and director in the new enterprise without dropping his connection as an officer. If it is granted that he may properly do so, can any objection be raised to his permitting the company which manufactures the new device to do business with the company of which he is an officer? And, if we grant that the officer may proceed to that extent, can objection be raised to his actively favoring the use of the new device by the company of which he is an officer?

The above case is purely hypothetical, and the various questions are raised, not because of their intrinsic importance, but to illustrate the numerous puzzling points that come up for decision as soon as an officer of a corporation acquires a personal interest in another company with which the corporation he serves is doing or might do business. The answers to such questions must usually be left to the consciences of those directly concerned. Higher and higher standards of business conduct are gradually becoming recognized, but it will be a long time before any definite rules to cover such questions as the foregoing are formulated. One or two conclusions which would probably be sanctioned by the general opinion of most leading business men are the following:

1. It is advisable at the earliest possible time, to reduce to a minimum the number of concerns controlled by its own officers and directors with which the company has contracts or is otherwise intimately connected. The whole arrangement is bad and should not be encouraged.

2. Wherever the arrangement is unavoidable, it should not be concealed but should be clearly stated and made known to all those who are directly and largely interested.
3. Whenever such a relationship exists, the contracts between the corporation and the related concern should be subject to criticism and correction by parties who are thoroughly competent and disinterested.
4. When a new company in a related line is to be organized by the officers of a corporation, and when they are to take an active part in its development, they should ordinarily begin by leaving the service of the first existing corporation.

There may be exceptions to all these suggested rules. However, business opinion is tending more and more, in the writer's judgment, toward favoring them.

"Unloading" and Securing Control

A somewhat different case arises when the officers of a corporation are financially interested in another company which has proved to be a money loser or which needs assistance. If the business in which they are interested is in any way related to the business of the corporation of which they are officers, it is frequently an easy and tempting procedure to "unload" a portion of their holdings or to secure financial assistance in some other form. The process is especially easy when the active officers are able to work together without interference in putting through their plans, and when their fellow directors have little direct personal knowledge of the details of the business. Under these circumstances, all that is required is to make representations and recommendations which can hardly be challenged unless the other directors wish to go to the extent of expressing lack of confidence in their own officers.

Sometimes schemes of the same general type may be put through with a view to enabling the officers to secure personal control, for their own benefit, of another company in which they are financially interested. By inducing the company in which they are officers to take stock additional to their own, they may be able to acquire the desired control. An example of a successful effort to procure both results—securing financial assistance for their corporation and at the same time obtaining control for themselves—is presented below. The facts are known beyond question to be substantially correct.

In this instance the officers of a prosperous publishing corporation had become involved to the extent of about \$75,000 in another publishing corporation, which had not proved to be a success. We will call the first-named company, A, and the second company, B.

At the time of the transaction, B had reached the point where its need for cash was desperate, whereas A was at the same time accumulating a large cash surplus which was not needed in its own business. It was natural that the officers who were interested in B should look with longing eyes toward the overflowing treasury of A.

The two officers most vitally concerned were themselves on the directorate of company A. They had as fellow directors two subordinate officers, who were to a large extent in their power, and two elderly professional men who were not familiar with the active management of the company's affairs or even with the line of business in which it was engaged. Under these conditions it was an easy matter for the two officers most interested to persuade the other two officers to join with them in putting through the deal they proposed. These two officers were not themselves large stockholders and to have refused would have meant placing themselves in an extremely uncomfortable position. Having their co-operation, it was a matter of no difficulty whatever to present to the other

two directors a misstatement of facts, which was accepted without question, and thus secure their assent. The result was that the six directors of corporation A unanimously approved the purchase of \$25,000 of stock in corporation B. This \$25,000 was sufficient to carry corporation B through the crisis then confronting it and at the same time to give to the two conspiring officers undoubted control over company B. Furthermore, having once secured so substantial an investment on the part of company A, they could reasonably anticipate that further purchases of B's stock would be made if additional cash were needed.

In the judgment of competent observers, the net result to corporation A is the probable, or at least possible, loss of the \$25,000 it has invested, combined with many other incidental disadvantages arising out of the connection.

Emboldened by the success of their first operation, the two officers have been making active plans for securing possession of valuable lists of names owned by company A for the benefit of company B; and, in view of what has already transpired, it is to be expected that the process of systematic "milking" will go on.

Misuse of Inside Information

Another common method of exploitation is through the misuse by officers or directors of information which comes to them on the "inside" but which is unknown to other stockholders or perhaps is unknown to all of the officers and directors of the corporation. This is most likely to occur in connection with speculation, either in the company's own shares or in products the price of which can be affected by the corporation's activities.

Widely separated instances of the last-mentioned form of speculation may be given. The early history of the National Cordage Company, which was organized in 1887 and which

has been referred to previously, was one of wise management and success. After about three years, however, two of the important executives became interested in an attempt to bolster up the price of sisal and hemp and devoted the resources of the company quite largely to this speculation. "The enterprise was changed from a business to a speculation. Extension of control became a mania with the officers and their ambition stifled their sound business judgment." Inasmuch as the National Cordage Company was by far the largest purchaser of the two products mentioned, it seemed as if the calculations of the officers, based upon their absolute knowledge of the company's own policy, could hardly miscarry. But they did not reckon on the fact that the resources, even of so great a company, are limited, and eventually so large an amount of capital was tied up in carrying great stocks of sisal and hemp that the company itself was forced into bankruptcy.

Another instance is to be found in the history of one of the large German banks operating in South America. The manager of its branch in Valparaiso became convinced a few years ago that, through its exchange operations the bank could control the market rate of exchange for Chilean currency. At any rate, in view of the positive information which he had, not only of the bank's operations but also of the operations of many important customers, the manager felt justified in believing that a little private speculation, based on this information, could not fail. But underlying economic factors upon which he had not counted worked against him. Eventually he was driven into making an actual misappropriation of banking funds—which had not been a part of his original plan—and even this desperate move failed to save him. The manager's mishandling of bank funds was exposed and he committed suicide. Afterwards the price of exchange took a more favorable turn and the bank came off, it is understood, with only a moderate loss.

As to the misuse of inside information for the purpose of speculating in the shares of their own company, innumerable instances might be given. The results are quite likely to be unfortunate for the officers, themselves, due partly to the fact that the information upon which they act is, in many cases, fragmentary, and due also to the fact, which many people fail to realize, that the up and down movements of stock market prices are determined only in part by the intrinsic merits of the securities. Fluctuations arise more largely from general economic and market influences, with which the officers of most industrial corporations are not especially familiar.

Is Exploitation a Common Evil?

As has been intimated at the beginning of this chapter, exploitation as a factor in business transactions is perhaps a more common evil than it was in the days when business organizations were simpler and under the more direct control of their owners. The officer or director of the modern corporation occupies a position, not merely of dignity and responsibility, but also of trust. This trusteeship is more clearly recognized, perhaps, than was the case a generation or more ago. But the ascendancy of the higher standards, which are implied in a sense of trusteeship, comes slowly and is the result of innumerable hard struggles. In the meantime, exploitation in its myriad forms goes on apparently unchecked, while, on the surface, financial transactions usually appear regular, and plausible reasons can easily be advanced for approving them; yet, once in a while a lawsuit or an investigation suddenly tears away the silken covering and reveals the ugly figures of greed and graft. Our surprise and dismay for the moment are acute; then we forget. We regain a feeling of security which remains until the next unpleasant incident occurs.

Sometimes what appears to be exploitation from the stand-

point of one corporation appears to certain of the directors in the light of proper loyalty to the interests of another corporation. Up to a few years ago the American Express Company owned 55,000 shares of the Boston and Maine Railroad and was represented on the railroad directorate by two able men. These men regarded themselves, and were regarded by their associates, as primarily engaged in promoting the interests of the American Express Company and not those of the Boston and Maine Railroad Company. Of course, these two sets of interests were, for the most part, unopposed to each other. Just before the American Express Company's holdings were sold, however, to the New Haven Road, the "onerous contract" between the Boston and Maine and the American Express Company which had been previously in force, was extended over a period of twenty years. The New Hampshire Public Service Commissioners made a finding that the loss to the Boston and Maine on this contract, as compared with an equitable arrangement, amounted to \$700,000 per year. No doubt the two representatives of the American Express Company on the Boston and Maine board worked for this contract. Were they morally justified in so doing? Assuming that the Public Service Commissioners' charges are correct, would we be justified in saying that these two directors had assisted in the exploitation of the Boston and Maine? The answer to these questions would depend upon whether they are to be thought of as primarily Boston and Maine directors or as primarily American Express representatives.

The incident just cited serves to illustrate one thought which should always be kept in view; namely, the great complexity of present-day business relations and the difficulty of arriving at clear and unquestionable decisions. Because this difficulty exists, it is not easy to form a worth while opinion as to whether exploitation is becoming more or less common, or even as to its prevalence. All that can safely be said is that

the gradual clarifying of the ethical standards which apply under modern complex conditions will undoubtedly tend to diminish exploitation.

Exploitation in Other Countries

In the discussion given above on corporate exploitation as an evil, there have been only a few incidental references to similar practices in foreign countries. Indeed, it is frequently asserted that both political graft and business graft are much more common here than elsewhere. As to the truth or falsity of this statement, it is practically impossible to reach a definite conclusion. But it seems likely that the habit of frank speaking and investigation in this country is at least in part responsible for the greater prominence here of scandalous cases of exploitation.

The same evils which have been described in this chapter are by no means unknown in other countries. As one special example, we may take the case of Lipton, Limited, the famous English tea importing and distributing house. It appears that for some months previous to the annual meeting which was held on August 24, 1915, an active investigation combined with changes in the executive management had been going on. Several new members of the board were secured and these men took active charge of affairs. First of all, they discovered that certain of the stock inventories carried were too heavy for the business being done, and that the values of stocks on hand had been seriously overstated: "In addition to the differences in the stocks, we were faced with a substantial shortage of capital, in consequence of several speculations having been entered into, which also resulted in considerable loss." The total losses shown were approximately £248,000, which were met by a "gift" of that amount from Sir Thomas Lipton, who shouldered the whole responsibility for the mishaps that had occurred during his administration.

The following remarks of the chairman of the meeting, as reported in the London *Statist*, will be found especially interesting:

He took it that the shareholders had one object, and one object only, and that was not to make things more difficult for the Company than was absolutely necessary. So far as he was personally concerned, he had not known Sir Thomas Lipton in any shape or form until five months ago, and the suggestion that he was representing any group was entirely erroneous. He was on the board entirely and solely in the interests of the shareholders of the Company.

Although there might be reason for the shareholders to criticize the past management and Sir Thomas Lipton, he would respectfully suggest that the time for such criticism has gone by, Sir Thomas had arranged to hand over to the Company £248,000 in cash as a gift. He had entered into an agreement to that effect, and the directors expected to get the first £100,000 next week or the week after. Under all the circumstances, it would be a great pity, and it might have disastrous results to the position of the company if they appointed a committee of investigation such as was suggested. He would frankly say that no committee of investigation could have accomplished what the new directors had been able to do quietly and without upsetting the business. He did not think the shareholders would find the new board making the same mistakes that the late board had done, and if the shareholders were prepared to give them a chance they would do their best for them. They had 459 branches and five tea shops. In regard to extensions, they did not intend to embark upon any what might be called big speculative developments. They would proceed cautiously, and he would ask the shareholders to leave it to the board to give them in the future an account of their stewardship. Under all the circumstances he appealed to the mover of the amendment to withdraw it.

Mr. Bickerton (a stockholder) withdrew his amend-

ment for obtaining a committee of investigation, and the resolution for the adoption of the report and accounts was carried unanimously.

These remarks sound strikingly similar to remarks which are frequently made in discussions of corporate transactions that occur on this side of the water. The story of corporate mismanagement, exploitation, and embarrassment is told only too frequently wherever commerce and industry are organized on a great scale.

Part 4

CHAPTER XXIV

EXPLOITATION BY DIRECTORS AND MAJORITY SHAREHOLDERS

Enlarging the Circle of "Insiders"

The preceding chapter disclosed some of the methods by which the active officers of a corporation may use their positions to carry through transactions which are primarily in their own interests and are injurious to the interests of all the other shareholders, including even their fellow officers and directors of the corporation. Now we have to consider instances in which the circle of inside schemers is enlarged so as to include all, or a majority, of the members of the board of directors, who misuse their positions to the injury of their fellow shareholders. The circle may be enlarged to include a majority of the shareholders who exploit the minority shareholders; or it may even be further enlarged to include all the shareholders who are banded together for the purpose of exploiting the creditors.

The principal methods employed do not differ fundamentally from those previously described, and may take the form of unfair contracts with a corporation, or of sales at exorbitant prices, or of misstatements of fact, thus misleading some of the outsiders into buying or selling at far above or below fair valuations, or of misusing the resources of the corporation to assist in outside ventures or speculations. These are the basic methods which in their infinitely varied forms are used again and again.

Some of these methods, which have already been presented, need not be further discussed in this chapter; others will be treated from a slightly different angle.

Juggling Accounts

It has been not uncommon, though this is an evil which is steadily diminishing, for directors of corporations to approve the issuing of income statements and of balance sheets which are plainly designed to give a wrong impression. One of the best-known examples of account juggling in American financial history is the case of the American Malting Company. At the formation of the company in 1897, it purchased from the previous owners of its plants 3,800,000 bushels of malt for which it paid 2 cents a bushel more than its cost value. During the first five months of its existence the company sold this malt at a profit of only about $\frac{1}{4}$ cent per bushel, a little more than \$10,000. Nevertheless, three months after the company commenced business, the directors declared the first dividend on the preferred stock which required a disbursement of \$219,000.

No financial statement had been rendered and, in fact, the general books of the company were unbalanced. Even three months later, without having a financial statement before them, the company declared a second preferred dividend; in other words they paid out nearly \$440,000 in dividends during the first six months, while their net earnings were about \$10,000.

Inasmuch as the directors were practical maltsters who operated plants which they themselves had sold to the company, there seemed to be no valid excuse for their mishandling of the situation.

International Cotton Mills Corporation Case

A more complicated case of juggling, but one of a type that is not at all infrequent, is that of the International Cotton Mills Corporation. At its reorganization in 1913, it was thought desirable to eliminate one of the subsidiary companies, the Consolidated Cotton Duck Corporation. Among the assets

of the last-named corporation were advances amounting to \$1,300,000 which had been made to subsidiary companies. These advances were transferred to another subsidiary, the Turner Company, which in turn increased its outstanding stock to the amount of the notes it received and transferred this increased stock to the International Cotton Mills Corporation. As a result, the nominal value of stockholdings of the International Company was increased by \$1,300,000. Inasmuch as this new stock really represented uncollectible debts, the fairness and soundness of the transaction are open to considerable question. Dewing very properly remarks:

Such methods of accounting are without doubt technically correct. . . . Yet, such technical evasions without proper explanation defeat the fundamental purposes of accounting by leading to confusion in the interpretation of a statement. It has been remarked, and it is the firm conviction of the present writer, that methods of accounting between a parent company and its subsidiaries are prone to give rise to deceptive entries.*

Baltimore and Ohio Railroad Case

In January, 1895, just about a year before the failure and reorganization in 1896, the president of the Baltimore and Ohio Railroad Company issued a statement which is typical of those frequently put out by officials of concerns that are becoming embarrassed. He said: "I can safely say the road has not been in so strong a position as now for at least fifteen years." Shortly afterwards, dividends on the common stock were passed. The company's own reports showed ratios of expenses to earnings of 75% in 1894, 80.2% in 1895, and 90.2% in 1896.

Receivers were appointed in February, 1896, and they at once selected Stephen Little as their accountant. His report was made in March but it was not given out until the

*Dewing's "Corporate Promotions and Reorganizations," p. 400.

following December. The report showed an overstatement of income during the period of seven years and two months which his report covered, as follows:

Overstatement of net income	\$2,721,068
Mischarge of worn-out equipment to profit and loss	2,843,596
Improper capitalization of charges under heads of construction and so on.....	2,064,741
Improper capitalization of so-called improve- ments and betterments	3,575,453
Total	\$11,204,858

Earnings had been increased by crude and arbitrary means. In 1892 the value of Western Union stock in the B. and O. treasury had been written up by \$468,038, and the stock of the Consolidated Coal Company by \$114,300. Advances to branch lines had been entered as assets and interest on these advances had been credited to income, although there was no reasonable probability that either one would ever be paid. The report revealed indorsements by the company of notes of subsidiary companies to the extent of \$5,481,835.

Mr. Little's report was in turn severely criticized by Messrs. Patterson and Corwin, who were appointed to re-examine the books of the company. However, these criticisms turned chiefly on the question as to what charges ought to be paid out of income and what ought to be capitalized. It is Daggett's opinion that Mr. Little was in general sustained and that "the B. and O. took its place with other American corporations, the management of which have indulged in secret juggling with the books."*

Atchison, Topeka and Santa Fe Case

Following is another example characteristic of railroad financing. The published reports of the Atchison, Topeka

*Daggett's "Railroad Reorganization," pp. 20-23.

and Santa Fe Railroad Company had shown a steady increase of net earnings from \$7,600,000 in 1890, to \$12,100,000 in 1893, but the investigation showed that the income had been overstated in these four years to the extent of \$7,000,000 or more, and grouped the understatements under four heads:*

1. Rebates: nearly \$4,000,000 in rebates to shippers had been charged not against earnings, but to an account entitled "Auditor's Suspended Account—Special," and so carried among the assets although they had absolutely no value.
2. On instructions from the financial office in the East, over \$2,000,000 were credited to earnings and \$781,000 deducted from operating expenses without any reason or excuse. These amounts were debited to "Auditor's Suspended Account."
3. \$488,000, according to the report, was improperly capitalized as improvements.
4. The company carried as an asset \$305,843 traffic balances which were in dispute and were in fact absolutely uncollectible.

Misleading Statements

While the technical intricacies of juggling corporate accounts so as to present false or misleading statements to the general body of shareholders and to the public cannot be here discussed, it is no doubt clear to every reader of this volume that many accounting entries are matters of judgment and good faith; and whenever one of these essentials is lacking, the company's accounting statements may be technically accurate and yet may conceal the truth. There are numberless variations in method.

*Daggett's "Railroad Reorganization," pp. 208, 209.

The objects sought in the deliberate juggling of accounts are also varied. One of the most common purposes is to make as good a showing as possible for the administration that is in power. Either it is hoped that later prosperity will permit the subsequent correction of any inflation of values that may be written on the books, or misrepresentation is resorted to as a desperate measure simply to stave off a revolt among the shareholders. Sometimes, also, it is essential—or the directors so believe—that the company should present a showing which will enable it to pay dividends so that it may redeem the promises that have been made to its security holders during the period of promotion. The American Malt-
ing case is an example.

Another common purpose is that of giving the officers and directors a chance to buy or sell the shares of their own company on the basis of the misleading statements which they put out. The simple process of purchasing shares below their true value on the strength of a poor, published statement and later reselling them in a boom market on the strength of some grossly inflated statement of earnings, has been so often repeated that it has become more or less familiar and in the larger corporations is not often attempted. The growing demand for adequate publicity has been a strong factor in suppressing the practice, and the resulting benefits have shown themselves most effectively in the higher prices for the shares of those companies which issue reasonably detailed statements at frequent intervals. The growth, also, of a well-educated financial public and the development of financial periodicals which cater to this public and which are constantly reviewing and analyzing published reports and statements, have been other important factors. But, while the old-time process has been refined, there has not been a total disappearance of the underlying purpose, which is to mislead outsiders into buying or selling at a deflated or an in-

flated price. In order to accomplish this advantage, it is not always necessary for the directors and officers to take active steps; they may simply withhold good news, or permit extravagant rumors of anticipated profits to circulate without contradiction. Some obscure change in methods of calculating reserves, which the directors approve with little or no question, may be quite enough in the course of time to bring about decided variations from normal in the published statements of earnings and of surplus.

Ethical Standards for Directors

These last remarks lead us back to the difficulties discussed in the preceding chapter of determining when and to what extent a director is morally justified in taking advantage of his position to make profits for himself. Certainly a director who realizes that his company is doing well and has good prospects is not to be blamed for going into the open market and purchasing more of its shares. In so doing he merely shows a proper confidence in the future of his company. On the other hand, when his business judgment tells him that dark days are ahead, is there any reason why he should not sell his shares to others whose opinion differ from his own? The distinction between what is proper and what is improper is perhaps to be found in the principle that the director may buy or sell as he chooses, so long as he is not basing his action on information that ought properly to be made public. The application of that principle is naturally left with each man's conscience.

The question as to whether directors ever have the right to use inside information for personal profit was the subject of a highly interesting investigation carried on in July, 1915, by a member of the editorial staff of the *New York Annalist*. The investigator went direct to a number of prominent directors, whose opinions he quotes. In order to secure frank

expressions and not merely virtuous platitudes, the opinions stated to the investigator are quoted without giving names.

The question was first put, according to the investigator, to one of the best-known bankers in the United States, who is a director in many corporations, including financial institutions, industrial companies, and railroads. His answer was in part as follows:

If we were all Christian gentlemen with a very fine sense of honor, I suppose no director would buy or sell stocks in his own company on information which comes to him as a director. As a practical matter nearly all directors do. If a director was a trustee it would be a different matter, but so far as I see he is not that. He is an administrator on behalf of himself and of other stockholders, but he does not surrender his individual freedom when he becomes a director. If it were held that a man's holdings of a stock should be frozen up the moment he becomes a director, he being put under obligation neither to add to them nor to reduce them, I fancy very few could be induced to become directors. There is this question to be considered. A director gives his time and ability to the management of a corporation and gets \$20 a week if weekly meetings are held. That is surely not compensation enough. What the director can make in the market on the basis of what he learns as a director is part of the pay which he gets for his work. It might be better if directors were paid a sum commensurate with their services and were then barred from dealing on their own stock, but as a practical matter it is not so.

A more advanced position is taken by a wealthy and powerful man described as "one of the self-made men of Wall Street," who said:

I am a director in both railroads and industrial companies and I know of my own knowledge that the chance to trade on inside information about railroad properties has become very small. Earnings are reported too fre-

quently for that. It is different with industrials. They do not report monthly, nor in all cases even quarterly, and between one annual report and another there is room for the use of inside information. There is a good deal of exaggeration about the big profits insiders make in the stock market. If they buy or sell they take a market risk and they are often wrong despite their inside information. Personally I am in favor of more frequent reports by industrial companies.

The next man interviewed took almost the contrary attitude, although even his remarks indicate a great advance over some of the practices that have been above described:

As for the director's right to use advance information to his own advantage, you must grant that self-preservation is the first law of society. A director has put his money into a company, given it a lot of his time, and is entitled to increase or diminish his investment in it on the basis of information which has not yet become public. If he knows of a profitable contract about to be closed, he has more right than any one else to benefit by a rise in the stock on the announcement, because he has helped to get the contract. Should he see bad times coming he is not morally bound to sit tight and see his shares decline. He has a right to sell his holdings, and he usually does.

An executive committee, of which I am a member, frequently meets at 3:30, adjourns for dinner and resumes discussions afterwards, lasting until late in the evening. We each get \$20 for attending. Recently we were able, by dovetailing our knowledge and experience, to put a transaction through that netted the company \$500,000. The total cost of our time to the company was under \$200.

As for taking advantage of one's position to put out misleading information or to shape reports so as to conceal the true condition of a company while the directors get out, that is simply criminal.

The argument thus given is controverted by another director—a partner in a private bank who says :

It is no argument to say that a director is not paid because he only gets his weekly or monthly fees for attending meetings. He is paid in the better insight into affairs which he is given. Being a director in two or three companies makes his time worth more to his own business. Paying a director several thousand dollars a year would make no difference in his speculations. If he speculates when he gets only fees, he will speculate just the same on a salary.

One of my companies has obtained large and, we hope, profitable war orders. Knowing of those, I feel that I have a right to buy stock if I want it. As a matter of fact, every one else seems to have known of these orders before we on the board did, for the rise started before we actually got the business. In that case our inside information did not tempt us.

Still another director, who is said to be speaking from long and wide experience, sums up his view of the situation as follows :

The situation is not unlike that which used to prevail before the railroads were forbidden to give passes to others than employees. Nearly every banker, big shipper, legislator, etc., knew that if he went to a railroad and demanded a pass, he would get it. I suppose 90% of such people took advantage of this and rode free. The other 10% held that they should pay their way and did. On ethical grounds, perhaps, 10% of the directors never buy or sell to take advantage of coming changes. In practice I have found that on my boards the directors get so interested in working out questions that they give little or no consideration to the probable effect of what they are going to do on the market, although I know that some outstanding event, like a proposal to declare a big extra dividend, would start most of us to buying more stock in order to take a little "flyer" on the news. There

has been a change in the ethics of directing in late years and there is much less speculation than there used to be when earnings were not made public every week or month.

The opinions above expressed are in many respects disappointing to those who believe that a directorship is primarily a position of trust, the holder of which should feel under the most exacting obligations of honor to work for the best interests of the general body of stockholders. The first director above quoted specifically denies that a director is a trustee and calls him an "administrator on behalf of himself and other stockholders." The distinction seems to be largely verbal, for the understanding that the director represents others and not merely himself remains undenied and undeniable. He surely cannot be said to be fulfilling his duties as a representative—dropping the word "trustee" for the moment—if he makes it his business to buy or sell stock on the basis of information that is concealed from those who are not members of the board.

And yet the five replies above quoted should not be regarded as wholly discouraging. On the contrary, the very fact that some directors, while frankly admitting that they and most of their associates take advantage of inside information, yet feel bound to defend their attitude, is in the nature of an admission that this attitude is subject to question. Compared with the attitude of the directors of many leading corporations twenty years or even ten years ago, it seems clear that there has been a change distinctly for the better.

Should Directors Be Compensated?

It will be noted that two of the five directors above quoted make the point that paying a director \$20 a meeting, which is the customary rate among the large corporations, really amounts to giving him no compensation whatever; and so far as concerns the prominent and wealthy men who are almost

universally chosen as members of the directorates of large companies, this is undoubtedly the case. The point made by another director that to pay such men a few thousand dollars a year would probably influence them only slightly, also appears to be well taken.

The question then rises as to whether the general practice of selecting as members of the board the largest shareholders or those who are most prominent and most influential, is sound. Would it not be better practice if the office of director were more commonly regarded as a salaried position which should be filled by a man who is expert in the corporation's line of business? Many of the smaller enterprises in European countries follow this practice. For example, most banks on the continent give their directors a percentage of the net profits or a percentage of the dividends actually paid. The men who become directors thus find it to their personal interest to build up the business and the earnings of the enterprise as quickly as possible. Their compensation is sufficiently large to give them an appreciable interest in the welfare of the corporation. As a result, the directorate becomes attractive to men who are not necessarily large shareholders and are not wealthy but who possess a valuable knowledge of the business. The directors in this case are practically superior officers who are expected to give a considerable proportion—although not the whole—of their time and energy to developing the business. However, this arrangement is confined largely to subsidiary corporations or to those which are controlled by powerful interests. It is probably not applicable, at least in this country, to independent corporations which are not controlled by any one man or by a capitalistic group.

Without attempting to proceed to the point of having the directors primarily salaried experts rather than primarily large or influential shareholders, it may be entirely practical and desirable to work gradually toward a combination of the two

systems; that is to say, many corporations might, with great profit to themselves and their shareholders, engage men as directors much as they engage men as officers. The chief difference would come in the fact that the director would probably be interested in some other independent business and would give only a portion of his time and thought to one company. In order to make it possible for such men to receive salaries which other directors would not receive, they might at the same time hold some other nominal office in the corporation.

It is not suggested that this plan would always be workable, but only that it might sometimes prove an excellent variation of the present practice. One desirable result would be not merely to bring specialized knowledge into the board, but also to increase the sense of responsibility and of duty to the shareholders which should be present in the mind of every director. It would assist in making it clear that a director is not expected to obtain his compensation at the expense of other shareholders, but only through the effect of his activities on earnings and on the market value of his own holdings. Whatever measures can be taken to dignify the position of director and to make clearer and more definite his proper relations with the corporation and with other shareholders, should certainly be welcomed and encouraged.

New Haven Railroad Case

As a striking example of the manner in which corporate affairs should not be handled, we cannot do better than cite the facts brought to light by an investigation of the Interstate Commerce Commission into the affairs of the New York, New Haven and Hartford Railroad. The Commission's report was published July 15, 1914.

It appears from the report that the affairs of the New Haven had been managed for several years with remarkable

laxity and extravagance. Although the directors were for the most part men of large wealth and of business standing, they left the actual control of affairs—even of broad policies—in the hands of President Mellen and of certain prominent directors. President Mellen himself was frequently uninformed as to the policies and in many cases as to the actual transactions on behalf of the railroad, which were put through by the small group of inside directors. Most of the members of the board seem to have become obsessed, under President Mellen's influence, with the idea that the New Haven Railroad should achieve complete control, at any price, of all the transportation agencies in New England. With that idea in mind, they approved expenditures for railroads, trolley lines, and steamship companies, which their ordinary business judgment would not have approved and which have turned out disastrously.

Westchester Railroad Case

Perhaps the most flagrant of these transactions was the purchase of all the stock and the assumption of all the liabilities of the so-called Westchester Railroad. This is a small suburban line which runs from the northern part of New York City to some of the outlying towns. Its total mileage is only a little over eighteen miles; yet the expenditure of the New Haven for this company was \$36,434,000, or well over two million dollars per mile. In judging this transaction, it must be borne in mind that the Westchester owned no valuable terminal properties and that it does not provide an entrance of any great value into New York City. The Interstate Commerce Commission says: "It is inconceivable that this enterprise could have been entered into by the New Haven as a result of the mandates of good judgment and proper railroading."

The purchase of the road was carried through by a special committee of the board of directors which was designated in

the minutes of the New Haven board of directors as being "on proposed competition between the Connecticut state line and Harlem River, with power." The last two words furnished the sole authorization for the subsequent procedure of the committee in purchasing the Westchester Railroad at an unheard-of price.

On November 18, 1907, the committee presented a brief report which stated that \$11,155,000 had been expended in obtaining control of the railroad, and that the company would have to spend many millions more in completing the construction which had been barely begun by the previous owners. The committee had made a contract with two presidents of banks which had loaned money to the Westchester Railroad, authorizing them to purchase for the New Haven 66% of the outstanding stock of the Westchester. "The contract is remarkable, in that no limit is placed on the amount that might be paid for the securities or expended in completing the road but these parties were to receive as a commission for their services $7\frac{1}{2}\%$ of the amount expended."

In spite of the fact that the brief report of the committee to the board gave no details or information, and in spite of the fact that certain directors, according to their later testimony, questioned the wisdom of the large expenditure involved, the report of the committee was unanimously approved, ratified, and confirmed.

Even President Mellen was not permitted to know any of the inside facts. In order to protect himself, he wrote upon the back of the report turned in by the special committee the following curious memorandum:

The trouble with this is there is nothing to show who got the money for the truck turned over. I don't like the looks of it, and I don't see why the matter should not be made plain. If I had the stock and sold it, I should expect others would state they had bought it of

me, but that don't seem to have been the disposition here. I never have known the first thing about who originally held the securities, what they were sold for, and no one has thought I was entitled to know. Perhaps I am not. I would feel better if there were at least a disposition to let me know something more than appears in the record.

A little later it developed that it would be highly desirable to purchase the minority stock of the Westchester as well as the 66% which had been previously secured, and something over \$1,500,000 was expended for this purpose.

The whole transaction was so secret and even mysterious that no adequate explanation has yet been given for the action of the special committee in going ahead with the purchase of this property. On this point the Interstate Commerce Commission says: "What could have been the motive for unloading the Westchester upon the New Haven at the expense of the stockholders of the latter must be left largely to conjecture." There is no room for doubt, however, but that the purchase of the Westchester was an extremely bad investment which would not have been approved if it had been fully and frankly discussed in the directorate of the New Haven or in any other group of level-headed business men.

Purchase of Transportation Companies

It seemed desirable to the management of the New Haven to conceal from the public its purchase of some of the transportation companies which came under its control. For instance, in purchasing the steamships and other equipment of the Metropolitan Steamship Company in 1910, general counsel for the New Haven had the title of the steamship companies transferred through no less than nine distinct corporations, all of which except the first one were subsidiaries of the New Haven. The report says: "The devious methods used, the

tangled web of corporate transactions through which this property passed, and the use of dummies, who knew nothing of the purposes for which they were being used, all clearly indicate that the purpose of these circuitous methods was to conceal the hand of the New Haven."

The Interstate Commerce Commission charges also that the management of the New Haven manipulated the accounting records of the company in order to conceal some of its transactions. In February, 1911, the New Haven purchased 23,500 shares of Rutland Railroad Company stock and gave in exchange its check for approximately \$2,365,000. No entries appear in the books of the New Haven Company which specifically cover this transaction. The stock thus acquired was on the same day delivered, together with a check for approximately \$135,000, to the New England Navigation Company—a New Haven subsidiary—and in exchange the Navigation Company gave its note for \$2,500,000. The whole transaction is so recorded, while the sum paid for the Rutland stock appears as a cash advance to the New England Navigation Company. Other similar instances are given.

A still more serious revelation is that so-called dividends on stock of subsidiary companies, which are recorded in the New Haven income account as actual earnings, were in reality paid with cash advanced from the New Haven's own treasury. For instance, the New England Navigation Company paid to the New Haven on June 29, 1912, a dividend of \$2,252,500; yet on June 26 the cash balance of the New England Navigation Company was only \$168,000. To enable the Navigation Company to pay the dividend in cash, the New Haven advanced over \$2,000,000 and received in exchange the Navigation Company's note. The effect of the transaction was to shift over two million dollars from one account to another, thus increasing the apparent income but without adding one cent to the real income or resources of the New Haven Company.

More than that, the New England Navigation Company was itself pursuing the same methods with its own subsidiaries. On June 24, 1912, the Navigation Company loaned to the Housatonic Power Company \$100,000 in cash and two days later received from the same company a dividend of \$105,000. On the same day the New England Navigation Company also loaned to the Hartford and New York Transportation Company \$100,000 in cash and three days later received \$101,000 in dividends. It is only too obvious that this juggling of cash between subsidiary companies was not sound business and that its effect was to produce a misleading income account.

If space permitted, the equally illuminating report of the Interstate Commerce Commission on the financial transactions of the Rock Island Company might be quoted. Both reports can be readily procured by any reader who is interested and both will repay careful study.

"Squeezing" the Minority Stockholders

As has been indicated above, exploitation is not confined to officers and directors as such. It may be an operation performed by, or on behalf of, the majority shareholders and directed against the minority shareholders. An excellent example of what may happen to minority stockholders may be taken from the history of the National Salt Company. This company was organized in 1899 and the majority of its stock was secured by another concern, the International Salt Company, in 1901. The minority of the National Salt holders, however, refused to exchange their stock and held out for better terms than those which were offered by the International Company.

After the International management came into control of the National Salt Company, the previous liberal earnings showed a sudden decline. Plausible reasons were offered for the decline and the new president remarked in his report

that, "the existing debts were created before the present officers came into power."

In August, 1902, the need of the National Salt Company for money was so great that it offered at auction sale a large part of the securities of subsidiary salt companies which it had held in its treasury. These securities were bid in for \$450,000 by agents acting for the International Salt Company. Shortly afterward a judgment for \$228,000 was entered by default against the National Salt Company on notes payable on demand to the International Salt Company. During the first six months of the same year the business had produced a net deficit of \$174,000, and the current obligations exceeded the quick assets by nearly \$300,000. In September, 1902, receivers for the National Salt Company were appointed. The natural result of the receivership was to bring about the dissolution of the company and the sale of its assets, enabling the International Salt Company to acquire possession of the company's property without settling with the minority stockholders.

In 1904 the New York Salt Wells of the National Salt Company were offered for public sale. Although the sale had been widely advertised, there were very few bidders and the president of the National Company bid in the property for a very small figure. The remaining assets of the company were later absorbed in much the same way by the International Salt Company, so that eventually the minority shareholders received nothing.*

It would hardly be worth while to enter into greater detail as to methods of exploiting minority shareholders. Perhaps the most common plan is to pay all the profits that are earned into the treasury of some other company owned by the majority shareholders. The payment may be made on any one of a number of pretexts. If the corporation is small, the

*Dewing's "Corporate Promotions and Reorganizations," pp. 219-225.

minority shareholders may find that every member of the majority party becomes an officer of the concern, and that all the profits are paid out in the form of salaries to officers.

These exploitations are becoming increasingly difficult as the courts tend more and more toward giving an equitable interpretation of the law governing corporations. Notwithstanding this modern tendency, it is found even yet that these exploitations are put through successfully.

Exploiting Creditors

Among small trading corporations the scheme is not unknown of purchasing a line of goods on credit, disposing of the goods, paying out the cash on some pretext, and permitting the company to go into bankruptcy. Operations of this kind are, in most instances, clear-cut acts of fraud and do not, therefore, fall within the scope of this chapter.

There are, however, some examples on a larger scale of similar actions. The creditor of a modern corporation counts as a portion of his margin of security the accumulated surplus of that corporation. As has already been set forth, this surplus becomes in effect a portion of the permanent capital investment and almost universally is not regarded as available for payment of dividends. Hence, when a bond issue of a corporation which maintains a surplus is floated, the issue is sold partly on the strength of the showing of surplus on the company's balance sheet. In 1899 a syndicate bought control of the Chicago and Alton Railroad Company, and in 1900 brought about a reorganization of the company. It was found by the syndicate's accountants that during the previous thirty-five years large sums had been charged to operating expenses which had really been invested in betterments and additions, and this sum was found to amount to over \$12,000,000. In recapitalizing, the syndicate sold \$22,000,000 of 3½% bonds, and out of the cash receipts declared a special dividend of

over \$6,000,000, which was indirectly charged against uncapitalized construction expenditure of \$12,444,170. In other words, the syndicate which controlled the stock, first sold bonds to raise cash and then distributed a substantial portion of this cash to themselves under the guise of dividends charged against surplus.

The process of paying dividends out of the cash secured through the sale of bonds is scarcely defensible under any circumstances. In this particular case the transaction can hardly be regarded in any other light than as exploitation of creditors who bought the bonds in good faith on the assumption that their money would be used for future betterments.

Fortunately, incidents of just this character are rare. The creditor is, on the whole, well protected both by the general provisions of the law and by the special provisions of his own mortgages and other securities. It is much easier to exploit shareholders, who are comparatively unprotected; consequently the creditor generally suffers only indirectly from the effects of exploitation.

Preventives of Exploitation

Fundamentally exploitation, even though it may take a form which is to some extent sanctioned by common usage, is a dishonest process. Men who are thoroughly fair and honorable in all their dealings will not be misled into taking action that looks toward depriving some of their business associates of property or benefits to which they are in equity entitled. Men of high standards of personal conduct will not descend to using positions of honor and trust for the advancement of their personal fortunes at the expense of those in whose behalf they are supposed to act. Especially is this true in the large corporations with their thousands or tens of thousands of stockholders who are attracted largely by the reputations of the management and of individual directors. Out

of the 26,544 shareholders in the New Haven on January 1, 1915, 10,813 were women, 3,522 were trustees or guardians, and 887 were insurance companies or other corporations. The directors of this company could well feel that they were in a position of immense responsibility in handling the funds of so many thousands of dependents.

Integrity of Directors

The obvious remedy against exploitation, it may therefore be suggested, would be for those shareholders who desire honest management to elect only directors of unimpeachable honor or to refuse to buy the securities of corporations which do not have such directors. As a matter of fact, this is the fundamental remedy and it is gradually being applied. But human nature is too slowly changed to make this remedy effective except over a period of generations. It is quite possible that in time, as corporate methods become better understood and standards become better established, we shall reach the point where attempts at exploitation will be as rare as actual robbery—in a legal sense—is today. But this period is as yet far distant. We have just read the testimony of one of the five directors above quoted who says that 90% of his fellow directors are not above taking advantage of their positions to make personal profits.

As matters stand today, it is quite impossible for the average shareholder of a large corporation to secure much information as to the personal characteristics and standards of the directors of his corporation. Even in small concerns, where the shareholders may be personally acquainted with each other and with the directors, it is often extremely difficult to gauge with any accuracy the true characters of the men who are in control. Of course, there is always room for the exercise of judgment. No one of good sense would deliberately place his capital under the control of men who are known to be of

bad character. The corporate shareholder, however, is always confronted with the possibility of having overestimated the characters of the men in charge, or again the control of the enterprise may be transferred into the hands of unscrupulous tricksters. For these reasons, the suggestion that each individual can protect himself from exploitation simply by carefully choosing the directors to whom he entrusts his capital, is true only within quite definite limits.

Special Provisions in Charter

A second suggestion has recently been made by T. Mulvey, Assistant Secretary of State, Ottawa, Canada. Writing in the *American Economic Review*, Mr. Mulvey first discusses the four methods named below of tiring out the minority stockholders and leading them to sell at an abnormally low price:

1. Piling up huge undistributed surplus.
2. Making a contract with a subsidiary company which permits the subsidiary to take most of the profits.
3. Paying out profits in the form of exorbitant salaries.
4. Selling out the profitable features of the enterprise to a new company, promoted by the majority.

Mr. Mulvey then points out that all these abuses may be controlled by the charter or by-laws, and says:

Salaries may be limited, the dealings with subsidiary companies for the purpose of withholding profits may be regulated, methods of accounting may be devised whereby dividends may not be withheld. A sale of the undertaking may be prohibited, except with unanimous consent. The shareholder has a contract with the company which is made up of the statutes, charter, and articles or by-laws. These may be framed so that exactions or overbearing methods of the majority may be eliminated.

It is quite true, as Mr. Mulvey suggests, that the charter and by-laws should be more carefully framed than is usually the case. They should provide, for instance, for cumulative voting, which assures even a small minority of some representation on the board of directors. In a few companies, the business of which is specially well stabilized and standardized, salaries, contracts, accumulation of surplus, and sale of assets may all be regulated. These companies, however are relatively few in number. The great majority of enterprises must be highly flexible in order to be successful. The difficulty of placing limitations of the kind Mr. Mulvey suggests, without at the same time hampering free action, seems in most cases insuperable. Moreover, how much can actually be accomplished by this plan? Charters and by-laws are subject to amendment; or, if not, they are outgrown in a short time and become intolerable shackles. If subject to amendment, the required two-thirds' or three-quarter vote can usually be secured on some plausible pretext without revealing the ultimate purpose in view. It may be noted that Mr. Mulvey does not discuss the following two methods of exploitation which are of great importance whenever officers or directors desire to take an unfair advantage: first, misrepresentation, i.e., the sustained policy of creating false impressions; and second, misuse of inside information. It would be hardly possible to prevent either of these abuses by regulation. And so long as they are available, officers and directors have it in their power to mislead their associates and often to procure their approval of actions which more complete information would show to be detrimental to their own interests. These weapons of concealment, misrepresentation, and misuse of information are the most formidable in the arsenals of the financial buccaneers. So long as they are permitted to work in the dark, little can be done by charter and by-law regulation or other formalities.

The Power of Publicity

On the other hand, the most powerful weapon available for the victims, or intended victims, of exploitation is publicity. Graft, trickery, coercion, and misrepresentation are poison plants that flourish in darkness and filth. Their greatest enemy is daylight. Letting in the daylight may not always kill them but at least it effectually stunts their growth. A shareholder in a corporation, large or small, who feels that he and his associates are being defrauded, who has a clear case and who is willing, with his eyes open, to enter into a long and gruelling fight, is likely to find simple publicity a highly effective, and, if properly used, a highly legitimate method of attack. In a large corporation the campaign of publicity may be directed not only toward stockholders, but toward the public at large. In a smaller corporation it will naturally be confined to people who are directly affected. It goes without saying that whatever statements are publicly made must be clearly based on unmistakable evidence presented without personal bias, in order that shareholders and others interested may be in position to form their own opinions. A single misstep—making a statement that is incorrect or presenting opinions as if they were actual facts—may be fatal to the whole case and may involve the one responsible in serious personal difficulties.

Through the use of effective publicity of the best type Justice Charles E. Hughes carried through an investigation of the life insurance companies which at first was quite insignificant, but which ultimately brought about, through the pressure of overwhelming public sentiment, a complete revolution in the financial management of the life insurance companies and a permanent uplift in standards of business morality. More recently, N. L. Amster, of Boston, carried on a campaign in behalf of the Rock Island stockholders which resulted in an agreement to select by general consent a new board

of directors in whom all the shareholders can place confidence. In 1914, the Interstate Commerce Commission used no weapon except publicity in carrying through the investigation of the New Haven Railroad, which revealed the facts that have been previously stated in this chapter and which led—through pressure of public opinion—to the retirement of the old management and the election of an entirely new group of directors and other officers.

Exploitation Condemned

Disinterested opinion, both among the public at large and among business men, today strongly condemns the practices which are grouped under the general head of "exploitation." A business man who is known to be unfair and dishonorable in his dealings, rapidly loses his credit and standing, even among men who may not themselves be wholly beyond reproach. No one wants to lend money or to become associated with a man or a group of men who have once been shown to be untrustworthy. Hence, even in a small corporation publicity of the right type may prove a powerful weapon against exploitation. Assuming always that it is properly used, it is a weapon that in the end will drive out, or at least will thwart the plans of, any officer or director who wishes to exploit his associates and yet has a certain business standing to protect.

The shareholder in a corporation who starts in to fight schemes for exploitation cannot reasonably expect a quick or easy victory. The people whom he attacks will presumably be well entrenched in power or they would not have ventured upon the objectionable course; they will never fail for plausible pretexts in favor of their proposals, nor will they lack supporters even among the men who in the long run will suffer by their schemes. The protesting shareholder will find that most of his fellow shareholders are skeptical

or completely indifferent; a small number may be willing to associate themselves with him, but his start is likely to be discouraging.

However—always assuming that the protesting shareholder has a good case and handles it properly—there is no real reason for discouragement. A movement in favor of decent and honorable methods of management is bound to attract more and more adherents and gain strength as it progresses. It should be the policy of those in charge of the movement to present their facts clearly—preferably in written form—and to keep hammering. If the statements of facts cannot be controverted they will become more and more convincing as they are reiterated and as new supporting evidence comes to light. It must be remembered that many of the shareholders who are skeptical or indifferent will change their attitude as they gradually become convinced of the truth and sincerity of the criticisms directed against the exploiters' schemes. If there is a fairly large body of stockholders, and if control of the corporation is not absolutely held by the exploiting faction, there is always at least a fighting chance that persistent yet restrained effort will eventually produce results. At any rate, there is no weapon other than publicity—or, as it might better be called, "daylight"—which can be relied upon.

It is obviously assumed in what has just been said that the schemes of exploitation which are being attacked are not within reach of the law. If it should be possible to make out a clear case of fraud, the situation would be quite different, and easier to handle than the problems discussed in this chapter. The methods of exploitation as treated here are more subtle in their very nature; they may not conflict with the laws of the state, but they violate the moral law and run counter to our fundamental conception of square dealing.

CHAPTER XXV

INSOLVENCY AND RECEIVERSHIP

Two Types of Insolvency

The number of business concerns which become insolvent each year averages a little below 1% of the total number. Following is the record for the last ten years.

	No. of Failures	No. of Business Concerns	Percentage of Failures
1905	11,520	1,357,455	.85%
1906	10,682	1,392,949	.77%
1907	11,725	1,418,075	.82%
1908	15,000	1,447,554	1.08%
1909	12,924	1,486,389	.80%
1910	12,652	1,515,143	.80%
1911	13,441	1,525,024	.81%
1912	15,452	1,564,279	.98%
1913	16,037	1,616,517	.99%
1914	18,280	1,655,496	1.10%

However, this record does not present a complete picture for it does not include numberless instances of financial embarrassment which are settled out of court. Nor does it include the still larger number of cases where a business concern gradually sinks its capital until finally the enterprise is sold or is transferred on some contractual arrangement, thus bringing the enterprise into the hands of new men who supply fresh capital which is either sunk or makes the business a success. Sometimes the process of passing a business concern from hand to hand, each new owner losing money until he reaches the point where he is glad to hand it over to some one else, is carried on over a remarkably long period. One

instance which has come to the writer's attention is that of a small magazine which existed for over twenty-four years. During this period it had an unbroken record of losing money, in addition to which considerable sums were sunk from time to time in supplementary publishing schemes, in furniture and equipment of various kinds, etc. During the twenty-four years the management and control were changed no less than fifteen times. Three different corporations were organized for the purpose of publishing the magazine, and other changes of ownership were effected through the sale of controlling stock. During its whole history this magazine was never insolvent and never was known to be in financial difficulties. The trouble seemed to lie in the secret conviction which every man carries in his bosom, that he could run a highly successful magazine if he chose to do so. Finally it reached the appointed goal of most small magazines and was absorbed by one of its stronger competitors.

Doubtless thousands of small retail stores and of many other business lines in which full and accurate accounts are not kept, lose money continuously over a period of years. No one outside the enterprise knows—with any definiteness at least—that as a money maker, it is a hopeless failure. Often the proprietor himself is not aware of this fact. There are many examples on a larger scale. Dewing calculates, for instance, that in eighteen years, from 1894 to 1912, the combination of cordage manufacturers under its various titles was continuously a business failure.

Economic Insolvency

This condition of being unable so to conduct a business that its net earnings will be more than sufficient to cover operating expenses and fixed charges, may be termed "economic insolvency." If the individual partnership or corporation that owns a business of this kind becomes unable or unwilling to

put any further capital into it, and also is unable to make an adjustment with creditors or to find a purchaser for the business, then the enterprise may come into the courts and be adjudged bankrupt.

An excellent example of economic insolvency is that of the San Antonio Land and Irrigation Company, Limited, which went into voluntary bankruptcy on November 4, 1914. The company filed a schedule showing liabilities of over \$8,000,000, and assets of approximately \$750,000. It had planned to build a large reservoir to store water for the irrigation of 60,000 acres of land. When the plant was completed the district suffered from a drought and the main assets of the company depreciated greatly in value.

Economic insolvency is sometimes defined as "the condition of a business enterprise that exists when the total value of assets is less than the total value of liabilities." In a money-losing corporation economic insolvency will sooner or later come, although it is often concealed by improper accounting.

Technical or Financial Insolvency

A second type of insolvency is that which exists when an enterprise that possesses a greater total of assets than of liabilities is unable to meet its obligations. This type is sometimes called "technical" insolvency or "financial" insolvency. It may easily happen that an enterprise which is a great business success may in this sense become insolvent. There have been previous references to the two insolvencies and reorganizations of the Westinghouse Electric and Manufacturing Company, which has been a big money-making enterprise. Various other examples have been given of insolvency due to lack of adequate working capital and need not here be repeated.

This second type of insolvency is probably more common

than the first. It is due, not to the intrinsic weakness in the business, but to errors in its financial management.

Causes of Insolvency

The causes of failures, as summarized by the commercial agencies, may be grouped in the following two main classes, viz., causes for which the management of the failing concern may be held responsible, and outside factors over which the business can exercise little or no control.

In the first group we find such causes as lack of capital, incompetence on the part of the management, the granting of unwise credits, etc. About 80% of all failures are due to this group of causes.

The second class includes such factors as losses by storms, floods, and similar disasters, unexpected failures of other concerns, severe competition, etc. This group of causes accounts for approximately 20% of the failures in the United States.

A few of these factors that are most closely related to the subject of financial management will be considered in the next few sections.

Lack of Working Capital

According to the mercantile agencies, the cause of a little more than one-third of the legal insolvencies in the United States is "lack of capital." This is rather a vague phrase which in the great majority of instances should probably be interpreted to mean "lack of working capital." By far the greater number of business enterprises can be made successful on a small scale even though their capital may be very limited. It is when these enterprises begin to expand and go beyond the prudent limits imposed by the small amount of available capital, that they tend more and more to transfer working assets into fixed assets and finally reach a point, if care is not exercised, where they cannot raise the ready cash with which

to meet maturing obligations. If we were to call the basic trouble in such cases "mismanagement of capital," we should not be far from wrong.

There are exceptional cases, of course, in which a minimum amount of capital is required in order to equip a plant or carry a sufficient stock of merchandise. It is stated, for example, that a modern sugar refinery which expects to enter into active competition cannot be built and equipped for less than from \$3,000,000 to \$5,000,000. Consequently, a sugar refining enterprise started with a capital of \$1,000,000 would probably have to build a small and inefficient plant, or else would issue interest-bearing obligations to such an extent as to endanger its financial safety.

The minimum limits of capital in each industry are so well known to those acquainted with the industry that there are probably comparatively few instances in which a business is started without sufficient capital—if it were properly handled—to carry it through to at least a moderate success.

Anxiety to Pay Dividends

A frequent cause of technical insolvency among industrial combinations has been excessive anxiety on the part of directors to pay dividends. It has previously been pointed out that many industrial combinations are started on the basis of excessive anticipation of profit, which has been aroused by glowing prospectuses, and the organizers feel called upon to "make good." Dewing says that in every one of the cases of failure cited by him, with the exception of the American Glue Company and the possible exception of the American Bicycle Company, financial difficulties were not in consequence of overcapitalization, as is usually alleged, but the "direct cause of failure in every instance was deflection of working capital to the paying of interest and dividends. Beneath these, as the fundamental cause, was the lack of judgment of promoters in placing

bonds upon an untried industrial enterprise, and the lack of conservatism of the early management in paying dividends without due regard to sound principles of finance."

Similar testimony is given by Mead as the result of his study of 26 industrial consolidations. "Every consideration of prudence," he says, "would incline the directors of these companies to reserve practically all of their profits in order to strengthen the financial position of their companies. So far from following the path of prudence, however, 61.9%—almost two-thirds of these profits—was paid out in dividends, leaving 38.1% for the surplus reserve. The inadequacy of this reserve may be better understood when it is compared with the outstanding capital whose permanent value it was intended to secure. A reserve of 4.2% is the net result of the operation."*

Unfavorable Market Conditions

Another immediate cause of technical insolvency, which is quite frequent among railroad corporations, is inability to meet maturing obligations by reason of market conditions. A company may be reasonably sound and well able to carry its load of indebtedness and yet may find itself in no position, at a given period when market conditions are unfavorable, to refund maturing bonds or to put out a new issue. This situation will very seldom arise with a corporation that enjoys really high credit, but it may easily arise with those that enjoy only fair to medium credit. The fact that an obligation falls due at an inconvenient time may be regarded as in one sense an accidental misfortune, though in another sense the corporation, if it had always been well handled, would probably not find itself in difficulties wholly by reason of an unreceptive market.

Though there are other causes for technical insolvencies, the three that have been named—deficiency of working capital,

*E. S. Mead, "Trust Finance," p. 178.

depletion of cash in order to pay dividends, and maturity of bonds or notes under unfavorable market conditions—may be picked out as those which are most usual.

Methods of Procedure in Case of Insolvency

When a business enterprise is unable to meet its debts and is known to be insolvent, four courses of action are open:

1. The owners of the bonds and other obligations and their creditors may agree voluntarily to a "readjustment" or settlement of their claims. This can be done only when all the creditors are reasonable and have considerable faith in the management of the enterprise. In that case, they may prefer, for their own sakes, that the situation should be kept out of the courts and out of public records and that the business should go on with as little disturbance as possible.

2. The corporation may voluntarily dissolve, divide its assets among its creditors, and go out of business, all without the intervention of the courts.

3. The individual, the partnership, or the corporation owning the enterprise may be adjudged a bankrupt, and a receiver in bankruptcy may be appointed to dispose of the assets and distribute the proceeds.

4. The corporation may secure the appointment of a receiver in equity whose function is to carry on the business and at the same time assist, so far as he can, in working out a generally satisfactory plan of reorganization.

Readjustment of Claims

The first of these remedies is unusual, except among the creditors of small corporations. It requires a degree of harmonious action that is almost impossible to bring about among a great number of people. The attempt, however, was made in July, 1915, in the case of the Missouri Pacific-Iron Mountain system under the auspices of one of the great banking

houses of America, Kuhn, Loeb and Company, who acted as readjustment managers. The details of the plan of readjustment need not, for this purpose, be considered. It was in fact quite similar in its general outline to the reorganization plans which are discussed in the chapter following. The point that interests us here is the fact that in spite of the obvious merits of the plan, its remarkably strong backing and the general indorsement of the financial press and of financial authorities, the final results were disappointing. It proved to be impossible to secure the voluntary assent of all, or practically all, the security holders, and it was found necessary to go through the cumbersome and expensive process of reorganization.

A similar attempt was made a few years ago in the case of the Hudson and Manhattan Company which operates the underground railway system through the Hudson River tunnel. In this instance the number of holders of obligations was much smaller and the plan of readjustment was successfully carried through. This plan is a very common procedure with smaller companies and, wherever practicable, is usually by far the most economical and most satisfactory method of meeting a condition of insolvency. Its success, however, is always dependent upon the presence of a fair degree of mutual confidence and good faith among the various parties concerned.

A typical embarrassment which did not involve any legal action is illustrated by the recent case of a \$2,000,000 printing and lithographing firm in New York City. This company had outstanding notes for \$400,000. At first it was thought to be in bad shape and the banks holding the notes were undecided whether any further accommodation should be extended. Representatives of the banks talked over the situation and a meeting of the creditors of the company was held at which a committee of five was appointed to decide on the proper steps to save the firm and protect its creditors. This committee agreed to put in temporary charge the head of a stationery and

printing house in whom all the creditors had confidence. He reported that the company had a cash balance of \$51,780, unfilled contracts on hand of about \$1,000,000, and bills receivable of \$150,000. On the strength of this report the creditors agreed to wait two years for a settlement of all claims. This fortunate result is primarily due to the wisdom and sympathy of the various creditors, almost any one of whom might have forced a bankruptcy. As one of the bankers remarked: "It would have been a crime if the house had been forced out of business, for I have learned positively that the company is doing a profitable business."

Origin and Nature of Receivership

A far wiser and less wasteful method than bankruptcy proceedings for handling the condition of insolvency in most large corporate enterprises, consists of addressing a petition to a court of equity for the appointment of a receiver to carry on the business under the supervision of the court, until some plan of reorganization is worked out. The petition is referred to in some jurisdictions as a "bill in chancery." It may be presented by any one of four parties: (1) by the corporation itself; (2) by the stockholders of the corporation; (3) by the secured creditors; (4) by the unsecured creditors.

Applications from the corporation itself or from its own stockholders are rare, and are still more rarely granted. Applications from creditors who are friendly toward the corporation are frequently presented, however, and in such cases the court is often requested to appoint one of the officers, or some one else close to the management, as receiver. "Friendly receiverships," as these arrangements are known, are not always warmly favored by the bondholders and other creditors who are usually somewhat suspicious of the management that is responsible for involving the company in financial difficulties.

Conflicting Receiverships

An application for a receivership may be addressed to any court, either federal or state, which has jurisdiction over any part of the business of the corporation. As a result it has often happened that two or more courts have each appointed a receiver and these receiverships have conflicted with each other.

The Northern Pacific receivership from 1893 to 1896 was marred by conflicts between federal judges as to jurisdiction. The receivers had originally been appointed in the Circuit Court of Milwaukee. In September, 1895, the judge of the Federal Court at Seattle, ruled that no part of the railroad was within the jurisdiction of the Milwaukee judge, and that any other court along the line of the road could therefore more properly and more efficiently administer the trust. As a result, other judges along the line appointed receivers of their own and a most confusing situation resulted. Finally, in 1896, four justices of the Supreme Court of the United States decided that the Federal Court at Milwaukee should be regarded as the court of primary jurisdiction. This settled a judicial strife that has not since been renewed.*

It has been not uncommon also for the federal and state courts to come into conflict in the same way. The tendency, however, has been strong toward putting all receivership proceedings that affect interstate corporations into the hands of the federal courts; and these courts almost invariably, as a matter of courtesy to each other, act in harmony. The judge who first appoints a receiver, is usually accorded precedence and other judges appoint the same man as receiver of the property over which they have jurisdiction. Sometimes the incipient conflict is solved by the appointment of an ancillary receiver, who is expected to co-operate strictly in harmony with the receiver first appointed.

*Daggett's "Railroad Reorganization," pp. 298-300.

Dissolution of Insolvent Corporations

The dissolution of an insolvent corporation and the distribution of the assets is an uncommon proceeding. It requires the consent both of creditors who must trust to the good faith of the officers of the corporation in carrying through the dissolution and distribution of the proceeds, and also of the shareholders who must be convinced that no other procedure is possible. As an example of the manner in which shareholders are likely to react toward a proposal of voluntary dissolution, we may take the following extract from an interesting account of the final meeting of the shareholders of the Dominion of Canada Trust Corporation, in London, in September, 1914. The meeting was reported in the London *Financial Times* as follows:

The Chairman (Mr. Emanuel M. Rodocanachi) explained, in reply to inquiries at the outset, that some of the directors were not present. Lord Denbigh, he added, was at the front.

A Shareholder: That is a good excuse. If everybody had acted as Lord Denbigh has acted we should not be in the straits we are today.

The Chairman proceeded to move a resolution providing for the winding up of the company, because, by reason of its liabilities, it could not continue business. He said that this course was necessitated by the action of the Royal Bank of Canada in forcing the sale of the timber properties held by the Maritime Lumber Company of Nova Scotia, whose shares and bonds were held by the corporation. The properties were subject to a debt to the bank of £150,000 which the corporation guaranteed. Owing to the financial crisis negotiations for the sale of the properties were not completed, and when the war came they fell through. The bank pressed on the sale, and the properties realized \$400,000. He was afraid there was no course open except voluntary liquidation, there being no funds to pay ordinary expenses or even office rents.

An amendment was proposed by Mr. Emery to the effect that the company should be wound up under the supervision of the Court. Some of the shareholders, he said, wished to see whether the remedies of the Companies Acts could not be used. When four years ago the company was floated the names of distinguished men, including Canadian statesmen, created the impression that fair play would be given the shareholders. It was never intimated that by this trust company they were going to launch a scheme which from the first was damned.

Captain Evans, who supported the amendment, addressing the Chairman, expressed a desire to deal drastically with him. ("Order, order.")

Some strong remarks ensued between Captain Evans and the Chairman, who said he would hazard a guess as to the amount of money represented in the room.

A Shareholder: "Will you refund the money that is here?"

The Chairman: "I have not a penny to bless myself with."

Mr. G. C. Swayne, a director appointed on behalf of the shareholders, said that while there had been great errors of judgment in getting mixed up with the timber property, everything had been frank and straightforward.

It was stated on behalf of the Board, that if after passing the resolution, any shareholder presented a petition for winding up under the supervision of the Court, it would not be opposed by the directors.

Eventually the amendment "to wind up voluntarily under the supervision of the Court" was carried, and, on the motion of a shareholder, the Official Receiver was appointed liquidator.

It is the feeling among creditors and shareholders alike, that those who have managed a corporation which has become insolvent, should not be left free to make their own arrangements for winding up the company, but should be checked

and supervised by some responsible officer who will unearth the facts. It is because of this feeling that the remedies of voluntary readjustment and of dissolution are so seldom used, and that the remedies of bankruptcy and receivership are almost always necessary.

Voluntary Dissolution

Dissolutions are not always due to insolvency, but may come as the result of pressure of other kinds or as the result of a conviction on the part of a majority of the shareholders that the corporation, while not actually insolvent or losing money, is nevertheless making an unprofitable use of the capital invested and is actually tending to deteriorate. Under these conditions, it may often be the part of wisdom to bring about a dissolution while the company still possesses a valuable surplus. A number of special cases of partial dissolution—which might also be described as a partial distribution of assets—have arisen in the United States recently, due to decrees of the courts requiring “combinations in restraint of trade” to resolve themselves into their constituent elements. The practical application of these decrees has in many cases involved peculiar difficulties.

For instance, a decree was entered on November 16, 1911, providing for the dissolution of the American Tobacco Company which, among other things, required the company before January 1, 1915, to get rid of its holdings of preferred shares in the British-American Tobacco Company, of ordinary shares in the Imperial Tobacco Company, of bonds of the Corporation of the United Cigar Stores, and of the preferred stock of the MacAndrews and Forbes Company. The Cigar Stores bonds were bought by the issuing company at par and retired. The British-American preferred shares were sold on the London market and the MacAndrews-Forbes preferred shares on the New York market in 1912 and 1913. Out of the proceeds of

these sales, the American Tobacco Company declared a special cash distribution of 20% on its common stock in 1912, amounting to \$8,030,480, and another of 15% in 1913, amounting to \$6,027,360. This left the ordinary shares of the Imperial Tobacco Company still undisposed of at the beginning of 1914.

As the Imperial stock is closely held and there is no wide market, it proved impossible to sell these shares except at an extraordinary sacrifice. It was therefore determined that the best plan was to distribute them pro rata among the stockholders of the American Tobacco Company. As explained in Chapter V, the Imperial Tobacco Company has three classes of shares—preference, preferred ordinary, and “B” deferred ordinary shares. On account of the unusual restrictions governing the transfer of the ordinary shares, it was necessary to make the holdings of the American Tobacco Company a new class designated as “Restricted ‘B’ Deferred Ordinary Shares.” These shares do not have the privilege, which belongs to the other ordinary shares, of subscribing to new issues of Imperial stock.

The number of American Tobacco Company shares outstanding at the beginning of 1914 was 401,824. The number of Imperial shares held by the American Tobacco Company was 360,729. A pro rata distribution was made on April 20, 1914, which gave each share of American Tobacco Company $360,729/401,824$ of a share of Imperial stock.

Instances of Voluntary Dissolution

Ordinarily there is no special financial skill required in order to handle the process of liquidation, which consists simply of gradually closing down the business, disposing of the assets, and distributing the proceeds to creditors and shareholders. Yet even this comparatively simple procedure involves a vast amount of detail work.

In the spring of 1914 the management of the United States

Express Company decided that in the face of the competition for express business, and particularly on account of the competition of the newly established parcel post, it would be best for the company to liquidate its assets and withdraw from the field. After the decision was announced the first step was to arrange for the transfer to other express companies of its valuable contracts and of many of its physical assets. Fortunately, there was little duplication of contracts or facilities among the express companies and most of this property could be disposed of to the remaining express companies at reasonable appraised valuations.

It was necessary to make complete inventories and this proved to be so long a task that in many cases wagons, horses, office furniture, leases, etc., were transferred first and valued afterwards. The equipment used by the United States Express Company in New York City represented an investment of between \$350,000 and \$400,000. Over 90% of the employees of the United States Express Company were taken over by the other large express companies. The remaining 10% were made up largely of employees who were retained in the service of the United States Express Company during the process of liquidation.

Origin and Nature of Bankruptcy

In the early English law an individual was declared bankrupt for the purpose of enabling his creditors to seize upon and distribute his assets. In case the assets did not prove sufficient to meet his debts, he was held personally subject to the remaining claims of his creditors, and in default of payment was thrown into jail. Within the last 150 years, however, the popular and legal conceptions of bankruptcy have been greatly modified.

The purpose of bankruptcy proceedings is no longer merely to protect creditors, but also to free the individual

from a load of debt that has become insupportable and set him on his feet again as a useful member of society. There are abuses, to be sure, of this modern practice. Cases are not unknown, both of individuals and of business enterprises, that have gone through bankruptcy proceedings for the prime purpose of clearing themselves of the legal obligation to pay their debts and afterwards have refused to recognize any moral obligation. But these abuses are, after all, comparatively rare. Individuals who have been able to rebuild their fortunes, after having gone through bankruptcy, have often made it a point of honor to repay in full all the debts from which they had legally been freed.

Bankruptcy proceedings in the United States are governed by the National Bankruptcy Act of 1898, and the courts having jurisdiction are those of the Federal Government.

Two Kinds of Bankruptcy

Bankruptcy is of two general kinds, voluntary and involuntary. The benefits of bankruptcy are open, not only to natural persons, with a few exceptions, but also to business corporations except those engaged in railroad operation, insurance, or banking. These three lines of business are of such general importance that it was thought not to be in the public interest to permit their operations to be brought suddenly to a close and their assets scattered. The process of winding up banking and insurance companies is provided for under the National and State Banking and Insurance Acts. The definition of "insolvency" as given in the National Bankruptcy Act is, from a legal standpoint, peculiar, although it conforms to the definition of "economic insolvency" that has been given above. A person is insolvent, within the meaning of the bankruptcy law, "when the aggregate of his property, exclusive of any property that he has conveyed, transferred, concealed or removed, or permitted to be removed with intent to hinder,

delay or defraud his creditors, is not, at a fair valuation, sufficient in amount to pay his debts." An individual or a corporation being in a condition of insolvency, must then commit an "act of bankruptcy" if the person or the corporation is to be thrown into involuntary bankruptcy.

The most common act of bankruptcy is the making of a general assignment for the benefit of creditors. As a general rule, a voluntary assignment for the benefit of creditors is less expensive than bankruptcy proceedings. It requires honor, mutual confidence, and good faith, while on the other hand bankruptcy procedure is especially valuable in case there is any suspicion of misrepresentation or dishonesty. Bankruptcy is a harsh and, for most corporations, a fatal remedy for insolvency. It is, in fact, hardly worth while to attempt to rehabilitate a corporation that has gone through bankruptcy. It is usually far easier and better to form a new corporation which will purchase the assets and proceed to carry on the business.

Receivers' Powers and Duties

The purpose for which a receiver in equity is appointed, is usually quite different from the purpose of a receiver or trustee in bankruptcy. The latter aims first to take possession of all the property of the insolvent individual or concern; next to dispose of the property as quickly as is practicable; and third, to distribute the cash that has been realized. A receiver in equity, on the other hand, has for his function to keep the business running as smoothly and with as little loss as possible. He may make some changes in methods of administration and may properly retrench whenever he can do so without impairing the efficiency of the property, but in general he carries on the business in about the same manner in which any business is carried on. He aims not to turn the assets into cash, but to keep working as profitably as possible. Not infrequently

the property of a corporation could not be sold for an amount sufficient even to reimburse the secured creditors; yet as a going concern it may be able to earn normal profits. This is the case, in fact, with almost all companies that have become technically insolvent. They are not, in the first place, properly subject to the Bankruptcy Act since their assets certainly exceed their liabilities, and to attempt to wind them up would be poor policy for every one concerned. The best and most common procedure with all such insolvent corporations, as well as with banks, insurance companies, and railroads, is to arrange—usually through friendly proceedings—for the appointment of a receiver to conduct the business while negotiations for its reorganization are in process.

The receiver carries on his work under the direct authority and supervision of the judge who has appointed him. The closeness of this supervision depends largely on the personalities of the judge and of the receiver, the general practice of the court, and numerous other factors. In general, the receiver makes it a point to secure special authority for acts that cannot be regarded as a part of the routine of conducting the business.

Under authority of the court, a receiver may issue obligations known as "Receiver's Certificates" which constitute a claim on the company's income and assets ranking ahead of all other claims. He may secure new equipment, bring new blood into the management, find new methods of marketing the company's products, and inaugurate new systems of operation. He is, in fact, the general manager of the company for the time being, with very little restriction upon his actions. Sometimes a receiver will remain in control for two or three years or more before a satisfactory plan of reorganization is worked out. It has been remarked above that the receiver is frequently one of the previous operating officials; on the other hand, it sometimes happens that the receiver

makes so satisfactory a record that he is requested, after the reorganization has been completed, to become an operating official and continue to work out the policies which, as receiver, he has inaugurated. F. W. Whitridge, for example, after successfully operating the Third Avenue Railroad Company in New York City as receiver, became and until his death continued to be president of the reorganized company.

Customary Results of Receivership

It is frequently the case that a corporation which becomes insolvent has for several years been running downhill, either because of incompetence or exploitation on the part of the management, or because the impaired credit of the company has not permitted it to raise new capital with which to bring its plant and equipment up to modern requirements. The appointment of a receiver, instead of being another step downward, may prove to be the company's salvation. That depends in part, of course, on the character and ability of the receiver. If he is a man of ideas and of executive talent, he may quickly rejuvenate the organization. As has just been noted, he has the power to issue receiver's certificates and thus secure funds which had previously been lacking. Sometimes a comparatively small amount of new capital will be enough to put a decaying corporation back into a moderately sound condition. The receiver has a free hand. If it is possible to do anything for the corporation and if he is the man to do it, the results of his activities may be a gratifying gain in efficiency and earning power. In any event, the receiver should be able to hold the organization and the property intact and to turn back, after his service is completed, a going and profit-making business.

Ordinarily the receiver takes some part also in an informal way in the negotiations for financial reorganization of the business and advises with the court as to the plan of reorgani-

zation that ought to be approved. It is an object of his efforts to bring about the reorganization and thus terminate the receivership at the earliest possible moment.

Very infrequently it happens that these customary results—maintenance of a going business and financial reorganization—are not attainable. And in that case the receivership may finally end in a forced winding up of the business. Although unusual, it is possible even for a railroad, like other business enterprises, actually and completely to go out of business. In October, 1914, the judge having jurisdiction signed an order directing the receivers of the Buffalo & Susquehanna Railroad to discontinue permanently the operation of trains, to take up the company's rails, and to dispose of its assets. It is stated that the total population served by this railway, which was 86 miles in length, was only about 17,000; consequently the railroad was wholly unable to pay its own operating expenses. At the time when the receiver wound up the business, all that was left to the owners of \$6,000,000 par value outstanding bonds (to say nothing of outstanding preferred and common shares) was the scrap value of the rails and rolling stock, the right of way, and 23 acres of land fronting on Lake Erie.

Such instances are so rare that they may be almost entirely disregarded. In the next chapter we have to consider the process of financial reorganization which goes on while the receiver is in charge, and the principles upon which reorganization of insolvent companies should be based.

CHAPTER XXVI

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REORGANIZATION

Purpose of Reorganization

In England the term "reconstruction" is used to describe the process that we ordinarily call "reorganization." The English word is better chosen as it embodies the idea which underlies the whole process; that of tearing down the old financial structure and using the materials in a new and stronger structure.

Financial reorganization, in its proper sense, is not merely a series of compromises and forced sacrifices imposed upon security holders. It is a rearrangement of the company's liabilities so as to make them conform more closely to the assets and earnings. If it is worked out on ideal lines the reorganization may be described as a new financial plan which replaces the old plan that has proved faulty. The readjustment of the company's finances should enable it to proceed thereafter under more favorable conditions and to achieve better results.

In each reorganization there are one or two specific purposes that stand out with especial prominence. The specific purposes that are most commonly found are the following:

- To raise more capital.
- To reduce fixed charges.
- To simplify the financial structure.
- To give increased facilities for raising capital in future.
- To eliminate unprofitable branches of the business.
- To pay or "refund" pressing obligations.
- To take care of an accumulation of unpaid preferred dividends.

The final plan of reorganization must be approved by a sufficient number of security holders and must also have the approval of the court. The relative influence of the security holders, on one side, and of the judge and receiver, on the other side, varies greatly in determining the plan of reorganization; and it is probable that in complicated reorganizations, especially those of railroads, it is more often necessary for the courts to intervene and take an active part in formulating a plan than it is in the simpler cases of reorganization, particularly of industrial corporations.

Conflicts of Interests in Reorganization

The various interests which are concerned in a financial reorganization may ordinarily be classified in three groups, as follows :

1. The creditors, including both the holders of floating debt and the bondholders.
2. The shareholders, both preferred and common.
3. The banking houses which are figuring on the underwriting of the reorganization plan.

In a complicated reorganization each one of these three groups is subdivided. There may be a number of bond issues which have claims that in part conflict with each other. The interests of the preferred and of the common shareholders are by no means identical. There may be two or more banking houses that are working on the reorganization with an eye to handling the underwriting. It may often happen, therefore, that there is a complex struggle among the various groups of interests. On some questions there may be agreements and alliances between two or more groups, and on other questions the cleavage may be entirely different.

Naturally the chief influence is exerted by the bondholders,

especially by the holders of those issues which are well protected by prior liens.

Next come the holders of the junior lien issues. The banking houses are likely to be in close touch with all the different groups of bondholders and advise with them. Inasmuch as the active assistance of some good banking house is essential in order to make any plan a success, the representatives of these houses are likely to be consulted and to have a voice in determining all important questions. Moreover, they are in the advantageous position of an outsider who may be trusted to view the situation impartially.

As for the shareholders in a drastic reorganization, they have little to say. Indeed, it sometimes happens that their claims to recognition are ruthlessly brushed aside and they are practically wiped out of existence. However, as we shall see, they are more commonly needed in order to supply the fresh cash required for the reorganized company, and for that reason are permitted to have some voice in working out the reorganization plan. The officers of a failed corporation sometimes undertake to direct the reorganization but their efforts are seldom welcomed. The receiver, as we have seen, sometimes takes a fairly active, though informal, part in working out the reorganization plan.

It must not be assumed that every reorganization necessarily brings an internal struggle for personal advantage or even for the advantage of holders of one class of securities. In the reorganization of the New England Cotton Yarn Company in 1903, the common stockholders were dealt with most severely, although these common stockholders were for the most part the very bankers and mill owners who were directing the reorganization.*

In view of all these complications and of the desirability usually of investigating the company's accounts, it often re-

*Dewing's "Corporate Promotions and Reorganizations," p. 325.

quires months or even years to work out a complete reorganization plan. In the larger reorganizations there is likely to be considerable discussion, not only among the security holders but also in the financial press. Attempts to curb and stifle this discussion are sometimes made and usually are unfortunate. The security holders of a company in process of reorganization are by no means entirely helpless. The assent of a large proportion of the holders of each bond issue is usually required before any plan can be made effective; consequently, the reasonable requests of security holders for explanations and for information in regard to the condition of the company cannot wisely be denied.

Turning again to an English example, we read in the London *Financial Times* of August 1, 1914, that on the previous day a meeting had been held of the bondholders of the San Antonio Land and Irrigation Company, an English joint-stock company owning a large tract of land in Texas. At this meeting charges were made by certain minority members of a previously appointed bondholders' committee that the majority members of the committee were not acting fairly and the discussion became somewhat personal and heated. After it had gone on for some time, the chairman interposed to say that he had no power to call the meeting to order; that in fact no meeting was being held and he "must be off." At this juncture one of the members of the committee commenced what appeared to be a personal statement, whereupon the chairman and some officials left the room. "A bondholder asked the directors to remain to answer any questions that might be addressed to them, but no reply was given, the directors left the room, and the meeting came to an abrupt termination."

It is, of course, always possible for those in charge of a corporation or of a reorganization, arbitrarily to refuse to proceed with a discussion, but the effect is not likely to be favorable to their cause.

Formation of Committees

In present-day practice one of the immediate results of the announcement of insolvency of an important corporation is the formation of a number of security holders' committees, each one representing a certain security issue. Sometimes one committee may represent two or more issues, the interests of which are not conflicting. The process of formation of these committees is nearly always something of a mystery. They seem to spring up sometimes overnight without special authority. As a matter of fact they are usually self-appointed and each committee is, in reality, simply a group of individuals who have determined among themselves that it is wise and proper for them to solicit authority from their fellow security holders to act in their behalf.

In order to secure this authority, it is essential that the members of the committee should either be personally well known to the security holders or should be connected with important firms or banking houses. In large reorganizations membership on these committees is regarded as something of a prize. The members are frequently allowed generous fees for their services and do not, as a matter of fact, have many onerous duties. The detailed work is usually handled by the secretary of the committee or by counsel. However, it would be an injustice to fail to point out that many reorganization committees composed of able men devote a great amount of time and effort to their work and sometimes, especially in the smaller reorganizations, give their services without compensation.

Even in the latter case, the fees of attorneys for the various reorganization committees must be provided for in the reorganization plan. Payments must be made to the managers of the reorganization and to the banks or trust companies which act as depositories for securities. The receiver's fees, plus the fees of the attorneys who advise with him, are nearly always

heavy. And, finally, there are numerous incidental expenses and fees for services of accountants, for advertising and circularizing in connection with the reorganization plan, and so forth, which aggregate a large amount. The expenses of reorganization are so heavy that members of reorganization committees are likely to persuade themselves that it makes little difference if they include a liberal compensation for themselves.

The self-appointed committee for a certain group of security holders does not always meet with instant acceptance. Security holders are likely to be somewhat skeptical. Unless most of the large holders are represented in the reorganization committee, they are likely to start an opposition committee and there may be an active struggle for proxies. If the opposition committee is at all successful, there may be later a merger of two committees, for it is clearly essential that there should not be dissension among any one group of security holders.

In the normal course of events, after several committees have been formed these committees begin to negotiate with each other and with the receiver with a view to arranging the best possible terms for the interests they represent. It is hardly possible for any general agreement to be reached except by a protracted series of negotiations and compromises and there must be some supreme judge or arbiter. Unless the receiver, some official of the company, or some influential person or banking house can assume this function and really take charge of the whole process of bringing about an agreement, it is natural and customary to select from the various security holders' committees a group which includes at least one representative of each set of interests that must be taken into consideration; this group is customarily known as the "Reorganization Committee." This is the committee that, in the final analysis, devises the plan of reorganization. The various security holders' committees may negotiate, but they are likely to follow the lead of their representative on the general re-

organization committee and in reality do little more than give their public approval to the final reorganization plan.

In spite of its drawbacks, including the ever-present possibility that not all the security holders' committees will conscientiously represent the interests entrusted to their care, the committee method of working out a reorganization plan is in most cases the only practical method. In a large corporation meetings of the security holders are quite impracticable; and if they were held they would be utterly useless so far as working out a plan is concerned. The only manner in which they could be advantageous would be in bringing about free and open election of members of the security holders' committees. In English practice this method of obtaining a committee is much more common than in this country. Even though their work may sometimes be careless, the various security holders' committees, through the general reorganization committee and frequently under the active direction of the banking house that is to handle the underwriting, do eventually agree upon a reorganization plan. On the whole, this method is probably the best that is available.

The same idea might be applied more frequently in smaller corporations, the security holders of which cannot effectively express their will. In a recent instance the majority shareholders of an oil-producing company were believed by the minority party to have driven the company into bankruptcy. The sale of its property and assets had been ordered by the Federal Court and a so-called "Reorganization Committee" composed of former officials was planning to bid for the company at this sale. At the last moment some of the minority shareholders appointed themselves a committee, secured the co-operation of a good proportion of the outstanding shares, employed a capable lawyer and incurred other necessary expenses which did not constitute a heavy burden on any individual shareholder, and presented their objections to the court.

These objections were sustained, and in the end the committee forced the adoption of a new and much more equitable plan. In this instance the prompt and courageous action of a few small shareholders checked what probably amounted to a conspiracy to obtain full control of the property.

Procedure in Reorganization

The first step in a reorganization after some person or group of persons—receiver, banking house, reorganization committee, or some one else—has been permitted to take charge of the process is to bring about a thorough examination and analysis of the accounts. It may be extremely unsafe to accept without question the accounting statements issued by the old management, for it is quite likely that their natural effort for several years has been to conceal the company's growing financial weakness. Until the actual earnings and expenses are definitely determined, no plan of reorganization that will hold water can be worked out. The examination may be both expensive and lengthy. While it is in progress, those actively engaged in the reorganization may carry on negotiations and work out a tentative plan, but no final result can be accomplished.

The second step consists of carrying on or completing the negotiations. Inasmuch as most of the members of the security holders and reorganization committee who must be consulted are likely to be men of affairs devoting only a relatively small amount of time and thought to the reorganization scheme, these negotiations are troublesome and are likely to cover a long period of time before any definite conclusions are reached.

In the meantime, as a third step, the receiver will be conducting the company with all possible economy. Perhaps, as set forth in the preceding chapter, he will be raising new capital, reforming the internal organization, and otherwise

raising the enterprise to a higher plane of efficiency. If the company possesses non-essential or non-profit-making property, the receiver may proceed, with the consent of the court, to dispose of some of its property. This, again, may be a long-drawn-out process.

The final step, when the reorganization plan has been worked out and accepted both by the security holders and by the court, is to select and put into execution the best legal method of accomplishing the financial rearrangement that has been agreed upon. In case the unanimous, or almost unanimous consent of the security holders has been obtained, the court may declare the plan operative and binding even upon the small proportion that have not given their assent. It is more frequently necessary, however, to go through the legal form of organizing a new corporation—usually with a name very similar to that of the insolvent corporation—and to bring about a judicial sale of all the property of the old corporation to the new corporation. The reorganization committee in that case will turn in the obligations of the old corporation in payment for the property, and will issue in exchange obligations and shares of the new corporation under the terms that have been agreed upon.

Sometimes stubborn security holders of the old corporation who are opposed to the reorganization plan refuse to exchange their securities for those of the new corporation. The result may not be especially pleasing to them, for they are likely to be left holding securities of a company which is non-active and for all practical purposes may be called non-existent. When the reorganization of the Northern Pacific Railroad Company took place in 1896, the holders of some 25,000 shares refused to exchange them for shares in the Northern Pacific Railway Company (the new company). Because of their opposition the old company is still kept alive but is, of course, inactive.

Raising Fresh Capital

Usually the most urgent problem in a reorganization is to bring in fresh capital, either for the purpose of making additions and betterments in the fixed assets, or more commonly for the purpose of providing adequate working capital. In either case it is necessary, in almost every reorganization, to secure a considerable amount of cash. If the company had been well supplied with cash it would not presumably have become insolvent. But the fact that a company is in receivers' hands is naturally no recommendation to prospective purchasers of its securities, and the problem of raising cash is therefore not only urgent but often extremely difficult. It can be solved only by enforcing drastic sacrifices on security holders. There are three possible methods of raising new capital or of securing an equivalent reduction in current liabilities:

1. By bringing out new issues of bonds or shares which are well secured and are offered on terms particularly favorable to purchasers.
2. By levying assessments on bond or share holders.
3. By inducing the current creditors, or some of them, to accept funded obligations in payment of the amounts due them.

In case the insolvent company's credit has not already been used to the limit, it may be possible to bring about some rearrangement of claims upon assets and earnings which will leave room for the issuance of new securities. These securities may then be sold at a heavy discount and thus the cash most urgently needed may be obtained.

A company which owns an ice and light plant in a small western city was recently in financial difficulties. At the original organization of the company some years before, only about one-half the cost of the plant, which amounted to

\$43,000, had been secured through the sale of shares; the remaining \$21,000 had been borrowed on one-year notes given by the corporation and indorsed by some of the larger shareholders. In subsequent years the company's obligations had been reduced to about \$17,000, but the creditors were pressing for payment and the indorsers of the company's notes were reported to be unwilling to renew their indorsements. As a matter of fact, there was a suspicion among some of the minority shareholders that the larger shareholders were willing to "shake them out," and, altogether, it was clear that some form of financial readjustment was necessary.

Inasmuch as the company was earning from \$2,000 to \$4,000 per annum, with good prospects for a future increase, it was found possible to sell at par a series of one- to ten-year notes, each note for \$1,200, bearing 6% interest. This provided \$12,000. The remaining \$5,000 was obtained by creating an issue of 8% preferred stock, which also was sold at par. Inasmuch as this was purely a local transaction handled by the shareholders themselves, there were practically no reorganization expenses. The common shares were necessarily called upon to make a sacrifice inasmuch as they could not reasonably expect any dividends for a period of some years; but after the payment of the ten-year notes, they presumably will be left with a valuable property which will yield a high rate of return.

In larger and more complex reorganizations precisely the same principle may frequently be applied. The income of the corporation which may be counted upon with reasonable certainty is taken away from the shareholders and pledged over a period of years to the payment of interest and repayment of principal of a new security issue. However, this plan is possible only on one of two conditions: a residue of unpledged property and income which has not been utilized in the preceding financing, or the drastic scaling down of the claims pre-

viously outstanding. The tendency in later reorganizations has been more and more strongly toward severe treatment of the old security holders with a view to providing for an attractive issue that will raise needed capital.

The second method of raising cash is through assessment. In nearly every reorganization the common shareholders are requested to pay some assessment in order to secure any holdings in the reorganized company. The same requirement is frequently imposed upon the preferred shareholders and is sometimes imposed even upon the junior bondholders. It may seem strange that a bondholder or even a preferred shareholder should be compelled to pay out fresh money in order to hold an interest in the company; but the truth is that any security holder who is not amply protected by marketable assets is likely to face this experience. If he resists the proposal a new company is organized which, at the judicial sale, will turn in the prior lien securities in payment for all the property of the company. This automatically wipes out the junior bondholders—unless they choose to raise the capital with which to pay off the prior lien holders, in which case they will hold the whip-hand. The junior bondholders or shareholders are thus left with the clear alternative of either giving up their previous investment without any further effort to protect and redeem it, or of paying the assessment.

When the Standard Rope and Twine Company was reorganized in 1905, the old first mortgage bondholders were requested to surrender their bonds and pay an assessment of \$262.50 for each \$1,000 bond. The old income bondholders surrendered their bonds and paid a cash assessment of \$52.50 for each \$1,000 bond. They received in return only \$440 par value of new securities. In this reorganization, which is one of the most drastic on record, the old shareholders were wiped out altogether.

Assessment is an extremely unpleasant thing for the se-

curity holder and naturally is accepted only as a last resort. However, it is usually unavoidable. Moreover, it is usually for the best interests of the corporation—and therefore for the best interests of the shareholders themselves in the long run—that the assessment method should be used.

Usually the shareholder who pays the assessment is given at least a nominal equivalent in the form of an increased amount of new stock. If he has faith in the company and its management, he may hopefully look forward to the time when this new stock will be worth its full par value. For example, in the reorganization of the M. Rumely Company, in 1915, we find that the common stockholders were required to pay an assessment of \$9 per share, in return for which they received new common stock plus an equivalent to their cash payments in the form of ten-year debenture bonds. At the failure and reorganization of the American Bicycle Company, in 1902, both preferred and common shareholders were assessed \$9 a share, for which each received new first preferred stock to the amount of their cash payment. In addition, the old preferred received a bonus of 50% in new common, and the old common received 25% in new common. The syndicate which underwrote the assessment was called upon to take up nearly 20% of the old stock, showing that in this case a considerable number of the old stockholders did not care to send good money after bad.

The question as to whether a shareholder should or should not pay his assessment is always one to be studied with much care. Naturally the reorganization managers will endeavor to make terms that will be at least fairly attractive in order to insure that the money which is required shall be forthcoming. For this reason it is usually profitable for shareholders to pay up their assessment. Daggett states that in almost all cases of railroad reorganization the price of the securities obtained by the assessment payer was within six months nearly equal

to the previous market quotation plus the assessment. In practically every case later quotations have gone much higher. The increase in value "has abundantly justified the payments which stockholders were asked to make." Probably the most drastic assessment on record is that of the Houston and Texas Central Railroad Company in 1897, which amounted to 73% on the common shares.

The third method of increasing cash resources—that of inducing the current creditors to accept long-term securities in settlement of their claims—is practicable only when the insolvent company is fundamentally prosperous and has been brought into difficulties merely through a temporary shortage in working capital. In both the Westinghouse reorganizations the holders of floating debt were easily persuaded to take long-term notes and bonds in payment, for they were convinced of the company's inherent soundness. In the first reorganization of 1891 the company's \$3,000,000 in floating debts were replaced largely by stock issues.

Reducing Fixed Charges

In the majority of cases of insolvency the trouble has arisen primarily because the company had a larger load of fixed charges than its income would permit it to carry. That being the case, the only safe and correct course in reorganization is to cut down these charges. It is useless to continue them unless the company's difficulties are partly temporary; for to do so would be simply to invite a new insolvency.

One of the simplest and most severe cases of cutting down fixed charges is that of the reorganization of the Northern Pacific Railroad Company in 1875. The company's line was at that time still under construction and its earnings were less than $\frac{1}{2}$ of 1% on its funded debt. There seemed to be no immediate prospect of increasing the earnings and it was therefore determined that all fixed charges should be eliminated.

All outstanding bonds were replaced by preferred shares; floating debt was also exchanged for preferred shares; and old common shares were replaced by new common shares.

Daggett points out that out of seven railroad reorganizations in the period from 1893 to 1898, every one showed a decrease in fixed charges averaging 31%. He suggests that experience shows the advisability of keeping in view, in the rearrangement of fixed charges, the five following principles:

1. The maximum fixed charges after the reorganization is completed should not exceed the absolute minimum of net earnings.
2. As large a proportion as possible of the charges should consist of interest on bonds, avoiding sinking funds, guaranteed dividends, rentals, and the like.
3. The losses should fall most heavily on the junior security holders generally, leaving the first lien securities—unless the reorganization is exceedingly drastic—practically untouched.
4. While fixed charges should be cut, the nominal value of the new securities received by security holders in the old company should be reduced as little as possible.
5. Bondholders whose claims are scaled down should be given a corresponding chance to participate in future increases of earnings.*

If the junior bondholder who is asked to accept a reduction in the principal and possibly in the rate of interest of his holdings, is at the same time given preferred and common shares up to the full par value of his former bondholdings, or perhaps a little above, he is inclined to accept the reduction much more readily. He may feel, quite properly, that there

*Daggett's "Railroad Reorganization," pp. 357-362.

is at least a chance of his recovering in future all the capital that he has lost.

As to industrial reorganizations, Dewing has averaged the results of 27 companies, and finds that fixed charges were reduced on the average about 25%. This percentage probably measures fairly well the excessive amounts of bonded and other obligations which were issued above the limits of prudence under the old financial plan.

The tendency on the whole has been more and more strongly toward avoiding half-way measures in reorganizations and toward putting the corporation on its feet financially so that it will not within a short time come back into the hands of the financial surgeons. To illustrate this tendency, an interesting parallel may be drawn between the first reorganization of the Erie Railroad in 1859 and its reorganization in 1895 by which time the present-day methods and principles of reorganization had become well recognized. In the first reorganization fixed charges were not reduced, preferred shares were given in exchange for the unsecured indebtedness, the second mortgage which was about to fall due was extended, and an assessment of $2\frac{1}{2}\%$ was levied on both preferred and common shares. The position of the road was not much stronger after the reorganization than it had been before, and the money paid in by the shareholders was dissipated without permanent benefit either to the corporation or to themselves. The reorganization of 1895, on the other hand, lowered fixed charges, procured ample cash by assessments on the shareholders, and gave shares rather than bonds in exchange for the new cash that was raised.

Effect on Financial Structure

One customary result of reorganization is an increase in capitalization. At first glance this may seem surprising, but it is the necessary result of the policy of compensating the old

security holders for their sacrifices by giving them some form of claim on the future earnings of the corporation. Junior bondholders are usually asked to accept a percentage of new bonds plus a percentage of preferred shares, the new securities having a total nominal value at least equivalent to the nominal value of the bonds they formerly held. The preferred shareholder is perhaps asked to pay an assessment and accept new securities consisting of preferred and common shares. The common shares may be reduced or wiped out, but more often, upon payment of assessment, are replaced by shares of not greatly reduced nominal value. In general, the tendency is strongly toward reducing bond capitalization and increasing the share capitalization more than proportionately.

Another customary result in large corporations is the simplification of the company's financial structure. In the years preceding reorganization the company has in all probability put out various issues of bonds, preferred shares, and common shares, some of which may have conflicting or uncertain claims. Reorganization gives an opportunity to replace these various small issues by a few large issues. At the same time, increased facilities for raising capital in future are often provided. The new issues are made large enough to provide for the immediate needs of the reorganized company, with the proviso that additional bonds may be sold under the same mortgage on fulfillment of the conditions, set forth in the deed of trust. Through this simplification and provision for future capital requirements the company's financial structure may be brought into line with the best present-day practice. This is often one great advantage of reorganization.

Another advantage frequently afforded by a reorganization is the opportunity to eliminate unprofitable branches or departments. Sometimes the bondholders who are secured by a mortgage or a branch or an isolated plant are bluntly told that they may take the property which is not wanted by the

parent corporation. More often, the fact that the property to which they have a claim is not essential, is driven home and they are forced to agree to a considerable reduction in their claims, which may be sufficient to put the outlying branch or plant on a profitable basis. Reorganization is apt to be carried on in a cold-blooded way by financial men who are impressed only by results that have actually been achieved. Frequently the main difficulty with a business that has become insolvent has been overoptimism and overexpansion on the part of its management. Wherever that is the case, a reorganization which eliminates these outside ventures or reduces the expense of conducting them may prove of great and lasting benefit to the corporation.

The Claflin Reorganization

As an interesting illustration of some of the principles above discussed, we may take up briefly the history of the failure and reorganization in 1914 of the great wholesale dry goods house of H. B. Claflin Company.

This company was organized in 1843. After a long period of prosperity the firm began to feel the effects of severe competition from jobbing houses in western trade-centers, and in order to meet this competition it began to build up its own retail outlets. Through certain controlled companies, particularly the Associated Merchants Company and the United Dry Goods Company 35 well-known department stores in various important cities were brought under the control of the Claflin interests. These stores naturally purchased most of their goods through the H. B. Claflin Company.

It is questionable whether the close relationship thus established between a wholesale house and retail stores was really valuable to either party. Of course, it enabled the H. B. Claflin Company to carry on extensive operations for a long period; but its apparent size and prosperity turned out to be

largely artificial and unsound. So far as the retail stores were concerned, it was evidently of no advantage to them to be compelled to purchase most of their supplies from a given wholesale establishment.

When the failure was first reported it was thought that the total Claflin liabilities amounted to about \$34,000,000, but it soon became evident that large amounts of notes had been issued and obligations incurred of which there was no clear record. The relationships of the many companies included in the combination had become so involved that it was months before the receivers could obtain even the approximate amount of the liabilities; and in the end the total liabilities were placed at about \$45,000,000.

It was found that the financial transactions of all the various department stores were being handled in New York and that the active managers of these stores knew nothing about many of the liabilities which the treasurer of their company, sitting in his New York office, had created. For instance, the Hennessy Corporation, which operated stores in Butte and in Anaconda, Montana, had on its books obligations amounting to only \$83,000. The president of this company had no knowledge whatever of the existence of any other obligations; but he was suddenly advised after the receivership of the Claflin Company that approximately \$1,700,000 in notes of the Hennessy Corporation had been issued and discounted in New York. The same practice was followed with subsidiary companies all over the country. In this way an enormous amount of "accommodation" paper was put out.

The scheme of reorganization finally agreed upon was based upon the idea that the wholesale business and the retail business of the combination ought to be separated. The *Dry Goods Economist* pointed out that, while the day has gone when a general jobbing house located in New York could do a great national business, there was still an important field open to

the H. B. Claflin Company in handling business within a short distance of New York.

The plan for reorganization was drawn up by and received the approval of the following committees: The Note Holders' Committee, the General Creditors' Committee, and the Creditors' Audit and Adjustment Association Committee.

The plan provided that the note holders receive in exchange for their old notes 15% in cash and 85% in three-year collateral-trust income notes issued by the new company which was to be known as the Mercantile Stores Corporation. The Mercantile Stores Corporation was to own all the stock of the insolvent department stores in the combination. It was also provided that a new company, known as the H. B. Claflin Corporation, should continue that portion of the wholesale business which had proven profitable. All the stock of the H. B. Claflin Corporation was to be owned by the Mercantile Stores Corporation.

Under this plan the new corporations were enabled to begin business without any current indebtedness and their prospects for success were considered excellent. The plan of reorganization was somewhat unusual in that it did not call for any new capital and at the same time freed the subsidiary corporations from current liabilities.

Reorganizations for Special Purposes

An extremely simple reorganization which did not in any way affect the financial structure of the company was that of the American Woolen Company of New Jersey in August, 1915. This reorganization is fully explained in the following extract from the official statement issued at the time:

The American Woolen Company is essentially a New England organization. With but one exception all its plants are located in New England; its executive headquarters are in Boston; its largest mills are situated in

Massachusetts; a very large number of its stockholders are Massachusetts people; the bulk of its taxes is paid in Massachusetts; and most of its financing is done in Massachusetts. For these and other reasons, including important advantages offered by the corporation and taxation laws of Massachusetts, it is the opinion of your directors that the interests of your Company as a corporation and of the stockholders individually will be best served by rechartering the Company as a Massachusetts corporation.

It is proposed that the new corporation shall issue amounts of preferred and common stock equal to those now outstanding of the New Jersey corporation, to wit, \$40,000,000 of preferred stock and \$20,000,000 of common stock; and that the relative rights and interests of preferred and common stockholders with respect to preferences, dividends, voting rights, etc., shall be the same in the Massachusetts corporation as they now are in the New Jersey corporation. The final result of the proposed proceedings will be that the assets and goodwill of the New Jersey corporation will be vested in the Massachusetts corporation, which will issue its preferred and common stock as above stated. The directors and other officers of the Massachusetts corporation will be those of the New Jersey corporation, with the exception of two inactive members of your board, one of whom is a resident of New Jersey. In other words, with the exception of some minor differences rendered essential by the statutes of Massachusetts, the rights and interests of the stockholders in the new corporation will be those in the old corporation.

A not uncommon reason for a simple reorganization is the desire to take care of accumulated unpaid dividends on preferred share issues. When a corporation, after a long period of small profits during which it has been impossible to keep up payments of preferred dividends, reaches a stage of prosperity that appears likely to be lasting, the common shareholders are often impatient at the prospect of continuing for

some years the slow process of paying up the back dividends while in the meantime the common shareholders receive nothing. On the other hand, the preferred shareholders, if they feel confidence in the continued large earning power of the company, may be entirely willing to accept securities in lieu of cash in settlement of their dividend claims. In 1914 the directors of the Western Power Company formulated a plan of this kind for funding back dividends amounting to 18% which had accumulated on the company's \$6,000,000 of 6% preferred stock. In substance the plan provided for a new corporation—the Western Power Corporation—which would have \$7,080,000 preferred shares at a par value of \$100 per share, and 146,700 common shares without par value. \$118 in new preferred was offered for each \$100 of the old preferred; while the new common was exchanged share for share for the old common.

A very simple method of reorganization when a going corporation needs more cash, is to persuade all the shareholders to turn back to the company a given proportion of their holdings, and then to resell this treasury stock for cash. This is a method commonly used among textile mills where the issuance of bonds is objectionable because of their bad effect on the bank credit of the companies operating in this field. The plan is obviously unworkable if any shareholder objects, and is applicable therefore only to corporations having but a small number of shareholders.

Reorganization to Secure Control

A manufacturing corporation in a small eastern city had been built up over a long period of years by its president and general manager. It was originally owned by the president as an individual but later was incorporated and shares were taken by some of his leading officials. At the time of his death the business was capitalized at \$600,000, of which the president

owned \$489,000, the general manager—who had become the active operating head of the plant—\$80,000, and the remaining shares were scattered among other operating officials. After the president's death his estate was handled by trustees who were desirous of putting the property into a well-secured form and did not wish to take any active part in the management of the business. On the other hand, the general manager was anxious to obtain control. Under these conditions, it was determined that the shares held in the president's estate should be exchanged in part for bonds of the corporation and in part for preferred shares. Inasmuch as the executors of the estate desired to withdraw a large part of the capital from the business in order to make a more diversified investment, it was further determined that the corporation and the executors should co-operate in carrying through a sale, to outsiders, of the preferred shares held by the estate.

A new corporation was then organized which issued \$200,000 in bonds, \$200,000 in preferred shares, and \$200,000 in common shares, and which gave its securities in exchange on an agreed basis for the common shares of the old company. The estate was still left with a small block of common shares upon which the general manager took an option. In the meantime, in order to secure his control, a voting trust agreement was entered into which gave the general manager full power to name a majority of the board. A sales campaign was then started to dispose of the preferred shares. Inasmuch as the corporation took part in the campaign, it was conducted in such a manner that no injury to the credit of the corporation resulted. It is understood to have been entirely successful. The general manager has exercised his option for the purchase of the estate's holdings of the common shares; and the final result, therefore, is highly satisfactory to all parties concerned.

The various purposes of reorganization are so numerous that they cannot all be discussed. The general principles set

forth and illustrated in this chapter, however, can always be utilized. Unless there is deliberate unfairness or stupidity on the part of some of the interests concerned, it is always possible to work out a scheme of readjustment or reorganization that will serve the best interests of all parties.

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